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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: 16 October 2006, London

Project: Insurance Contracts Phase II

Subject: Overview of papers for this meeting (Agenda Paper 5)
Review of the Board's tentative conclusions (Agenda paper 5A)
Customer relationships, policyholder behaviour and acquisition costs (agenda paper 5B)
[Separate observer notes cover agenda papers 5C, 5D and 5E-F]

AGENDA PAPER 5 Overview of papers for this meeting

Purpose of this paper

1. This paper summarises the papers for this meeting, and the estimated timetable up to the publication of the discussion paper (preliminary views).

Papers for the October meetings

Topic	Paper
Review of tentative conclusions in the light of industry proposals	5A
Customer relationships, policyholder behaviour and acquisition costs	5B
Comparison of Board conclusions and industry proposals - table	5C
Project update from the IASB website	5D
Cover note to examples	5E
Examples illustrating differences between the Board's tentative conclusions and industry proposals	5F

Timetable

Topic and summary of content	Date
To finalise preliminary views for inclusion in the discussion paper (other than participating contracts and universal life)	This meeting
Education session, primarily to update FASB members on the progress of this project	Joint meeting October 2006
Policyholder participation rights	November 2006
Universal life contracts	November 2006
First pre-ballot draft	November 2006
Sweep issues [if needed]	December 2006
Second pre-ballot draft	January 2007
Ballot draft	January / February 2007
Publication	February / March 2007
Comment deadline	To be determined
Policyholder accounting: The Board confirmed in May that the Discussion Paper will not address policyholder accounting. The staff will ask the Board to consider whether a separate discussion paper is needed on policyholder accounting.	First quarter 2007

Discussion paper – draft chapter headings

Chapter 1 Introduction

Chapter 2 Recognition and Derecognition

Chapter 3 Measurement – core issues

Chapter 4 Renewals, customer relationships

[including acquisition costs]

Chapter 5 Measurement – other issues

Chapter 6 Participating contracts

[including unit-linked and universal life, or put these in separate chapter[s]?]

Chapter 7 Changes in insurance liabilities

Chapter 8 Other issues

[eg Investment contracts]

Appendices

Appendix A Glossary

Appendix B Draft guidance on cash flows

Appendix C Draft guidance on risk margins

Appendix D Issues not covered in this discussion paper

Appendix E Other relevant IASB projects

Appendix F Summary of the Board's preliminary views

Appendix G Summary of questions for respondents

Appendix H summary of proposals by some insurance trade associations [and comparison with the Board's preliminary views]

AGENDA PAPER 5A Review of the Board's tentative conclusions

Purpose of this paper

1. In September, Board received a briefing from insurance trade associations. In the light of that briefing, this paper reviews the Board's tentative conclusions.

Summary of staff recommendations

2. The staff invites the Board to consider whether 'current exit value' is the most helpful label for the measurement attribute at this stage of the project. The staff suggests 'market-consistent current value' as a possible alternative (but with the same intended meaning).
3. In the other areas covered by this paper, the staff recommends no change to the Board's tentative conclusions.

Background

4. In September, various insurance trade associations presented to the Board a summary of their recommendations in the following recent publications:
 - (a) *Elaborated Principles for an IFRS Phase II Insurance Accounting Model*, by the CFO Forum (of about 20 major European insurers)¹
 - (b) *An International Accounting Standard for Life Insurance*, by the Group of North American Insurance Enterprises (GNAIE) and four major Japanese life insurers²
 - (c) *GNAIE Extended Principles for Non-life Insurance*, by GNAIE.
5. Because this paper focuses on differences between the trade associations' recommendation and the Board's tentative conclusions, it might be easy to overlook the main common points. These include the following:
 - (a) A measurement of an insurance liability is based on three basic building blocks:*

¹ http://www.cfoforum.nl/elaborated_principles.pdf

² <http://gnaie.net>

* As discussed later in this paper, GNAIE would measure non-life claims liabilities on an undiscounted basis, with no margins. GNAIE and the CFO Forum would permit an unearned

- (i) explicit current, unbiased probability-weighted estimates of future cash flows
 - (ii) the time value of money
 - (iii) an explicit margin
- (b) An insurer should report profits as it is released from risk.
- (c) An insurer would not report significant gains or losses at inception, unless the pricing of a contract is in line with what market participants require.
- (d) Insurance liabilities should be measured on a portfolio basis.
- (e) If future cash flows depend on policyholder behaviour, those cash flows should be included, within specified limits, in the measurement.
6. In the light of the trade associations' recommendations, the rest of this paper discusses whether the Board should change its tentative conclusions in the following areas.
- (a) Separate approaches to life and non-life insurance liabilities (paragraphs 12-21), with particular reference to non-life claims liabilities (paragraphs 15-17) and non-life pre-claims liabilities (paragraphs 18-21)
 - (b) Initial measurement – gains at inception (paragraphs 22-24)
 - (c) Risk margin (paragraphs 25-26)
 - (d) Service margin (paragraphs 27-32)
 - (e) Initial measurement – loss at inception (paragraphs 33-34)
 - (f) Measurement attribute (paragraphs 35-41)
 - (g) Basis for estimates (paragraphs 42-44)
 - (h) Review of assumptions (paragraphs 45-49)
 - (i) Discount rate (paragraphs 50-53)

premium approach for non-life pre-claims liabilities, on the basis that this is generally a reasonable proxy.

(j) Unbundling (paragraphs 54-55)

(k) Credit characteristics of insurance liabilities (paragraphs 56-57)

7. Because many of these issues are inter-related, the appendix to this paper summarises the more important relationships between them.
8. Agenda paper 5 B addresses customer relationships, policyholder behaviour and acquisition costs. We plan to discuss participating contracts and universal life contracts further in November.
9. Agenda paper 5C (an updated version of September agenda paper 19A) is a high-level tabular comparison by the staff of the industry's recommendations and the Board's tentative conclusions.
10. The trade associations emphasise that they view their recommendations as a coherent package and warn that piecemeal changes to one component could undermine other components.

Insurance supervisors

11. In May 2006, the International Association of Insurance Supervisors (IAIS) issued *Issues arising as a result of the IASB's Insurance Contracts Project – Phase II Second Set of IAIS Observations*,³ following an earlier set of observations issued in 2005. A representative of the IAIS presented the IAIS's views to the Board at an educational session in June. In areas covered by this paper the IAIS observations are largely consistent with the Board's tentative conclusions, so this paper does not repeat the IAIS observations in detail. In relation to areas discussed in this paper, the following IAIS observations are worthy of particular notice:

- (a) An exit model is preferable but profit on inception should be recognised only where an appropriate and sufficiently reliable risk margin has been provided for in the value of liabilities.
- (b) Similar obligations with similar risk profiles should result in similar liabilities.

³ http://www.iaisweb.org/060601__Second_Liabilities_Paper_final.pdf

- (c) The credit standing of an insurer should not be considered in the valuation of its insurance liabilities.

Separate approaches to life and non-life insurance liabilities

12. The Board's tentative conclusions apply the same approach to all insurance contracts.

The CFO Forum also supports a common approach to all insurance contracts. However, GNAIE argues that it is inappropriate to apply one uniform accounting model to both non-life and life contracts because of the following fundamental differences:⁴

“Firstly, the severity of the volatility of claim amounts is more uncertain for non-life relative to some life contracts. In contrast to many life contracts for which the amount of the payment from the insurer to the insured is generally certain (i.e. the “face amount” of the policy), non-life contracts only require a payment be made from the insurer to the insured if an insured event were to occur, and often expire without any such loss payment being made or only a portion of the policy limit paid. Therefore, for many life contracts there is generally uncertainty only on the timing of the claim, whereas, for non-life contracts there is uncertainty as to both the timing and settlement amount of loss payments.

Secondly, on an aggregate book of business, the level of uncertainty in timing of payments to insureds is greater for non-life than some life contracts for the following reasons:

- Key factors influencing the timing of payments for life contracts tend to be more stable relative to the key factors for non-life contracts. For many life contracts, key factors affecting the timing of loss payments in a given year, such as deaths, lapses, or withdrawals, are less susceptible to significant deviation from external factors from period to period. The timing of loss payments for non-life contracts is highly unpredictable and more susceptible to significant deviation from period to period due to factors such as the effect of global claim settlements, reinsurance commutations, weather, catastrophic events, the legal environment, the business environment, technology and claim settlement strategies. For example, for auto insurance there is uncertainty as to whether an insured would be involved in an auto accident in any given year, not to mention the challenge in predicting accurately the severity of any potential loss if an accident were to occur.
- Once losses are incurred, payments on non-life contracts tend to be far less predictable relative to life contracts. Many life related claims tend to settle relatively quicker, whereas non-life claims, particularly for long-tailed business, may not be reported until many years after the loss is incurred and even then may have protracted negotiation and/or settlement periods (e.g. asbestos and environmental claims).
- For many non-life contracts, the insurer has an obligation inherent in the contract to defend the policyholder. Such obligation affects the amount and timing of payments. This is not a factor for most life contracts.

⁴ The Japanese life insurers comment only on life insurance.

These distinct differences and features must be factored into the development of extended principles for both life and non-life insurance contracts. Based on these differences we believe that it would not be appropriate to use the same measurement attributes for both life and non-life insurance contracts. Specifically, given the greater uncertainty of both the amount and timing of payments for non-life relative to most life contracts certain variable estimates, such as a discount and explicit risk margin, are inherently less reliably measured for non-life relative to life contracts.”

13. We discuss below GNAIE’s proposals for non-life insurance, focusing separately on claims liabilities (paragraphs 15-17) and pre-claims liabilities (paragraphs 18-21). The **claims liability** is the liability to pay valid claims for insured events that have **already** occurred, including claims incurred but not reported (IBNR). The **pre-claims liability** is the stand-ready obligation to pay valid claims for **future** insured events arising under existing contracts, in other words, the obligation relating to the unexpired portion of risk coverage. A more conventional name for the pre-claims liability is unearned premium.
14. As implied in GNAIE’s comments, substantially all life insurance liabilities are pre-claims liabilities because claims are typically not contentious and are settled soon after the insurer is notified of an insured event.

Non-life insurance claims liabilities

15. GNAIE recommends that non-life insurance claims liabilities should be measured ‘based on the management’s current best and unbiased estimates of future cash flows without an explicit margin for risk and uncertainty or discounting’. GNAIE offers the following arguments against including discounting and risk margins:
 - (a) Discounting is inappropriate because of the highly unpredictable payment patterns of most claims. Adding additional variables relating to discount rates and the payment patterns would compromise the reliability and comparability of the measurement
 - (b) Discounting and risk margins would make the adequacy of the claims liability less transparent to users. The absence of discounting and explicit risk margins facilitates comparisons between reported liabilities and actual payments.
 - (c) Slight alterations in the timing of estimated cash flows could substantially increase the volatility in reported earnings without significant benefits for users, investors and other third parties.
 - (d) A broad-based consensus has not been reached on how to determine risk margins.

16. In the staff's view, although discounting and risk margins may cause some increase in both subjectivity and cost, the increase in relevance outweighs these concerns, for the following reasons:
- (a) Insurers and investors are not indifferent to the timing of cash flows. An amount payable tomorrow is not equivalent to the same amount payable in ten years. If a balance sheet measures those obligations at the same amount, it does not represent faithfully the insurer's financial position and is less relevant to users.
 - (b) Discounting eliminates the incentive for transactions (for example, some financial reinsurance transactions) that are designed, as an accounting arbitrage, to capture a selective portion of the economic realities excluded from undiscounted measurements.
 - (c) IFRSs already require discounting for all other comparable items, such as long-term provisions, employee benefit obligations and finance leases. Extending discounting to all insurance liabilities will make financial statements more internally consistent, and hence more relevant and reliable.
 - (d) The inclusion of a risk margin differentiates liabilities that are economically different.
17. The staff recommends no change to the Board's tentative conclusion on non-life insurance claims liabilities: these liabilities should, as is proposed for all insurance liabilities, be measured on a discounted basis, including an explicit risk margin.

Non-life insurance pre-claims liabilities

18. GNAIE and the CFO Forum suggest that an unearned premium approach would be a reasonable approximation for the pre-claims period of many short-duration insurance contracts. This approach would:
- (a) measure the liability initially at the premium received (less relevant acquisition costs, if these are not recognised as an asset).
 - (b) subsequently, measure the pre-claims liability as the unearned portion of that net premium.
 - (c) use a liability adequacy test (at inception and subsequently) to determine whether any additional loss needs to be recognised.

- (i) GNAIE's liability adequacy test would test whether '[t]ogether with anticipated future investment income, the pre-claims liability is sufficient to provide for claim payments and related expenses'. In other words, GNAIE would compare the unearned premium with current estimates of future cash flows, discounted (at a rate above the risk-free rate⁵) and with no risk margin.
- (ii) The CFO Forum's liability adequacy test would refer to the amount 'required by another insurer to take over the portfolio'. In other words, the CFO Forum would compare the unearned premium with current estimates of future cash flows, discounted (at the risk-free rate) and with a risk margin.

19. The following arguments might support an unearned premium approach:

- (a) For these contracts, unearned premium may be a reasonable proxy for current exit value, but obtainable with less cost and effort.
- (b) Most existing accounting models use an unearned premium approach and users are accustomed to using information about earned premiums and incurred claims to derive important ratios, such as claims ratios⁶ and combined ratios.⁷
- (c) An unearned premium approach is more consistent than a prospective approach with the customer consideration approach being explored in the project on revenue recognition.

20. For short duration contracts, the pre-claims period is short (eg six months on average for an annual contract). Moreover, if significant changes occur during that short period, the changes are much more likely to lead to losses than to gains, and if losses exist a robust liability adequacy test would detect them. Therefore, the staff agrees that the unearned premium will often be a reasonable approximation to current exit value for these contracts if the contract is not likely to be highly profitable or highly unprofitable, and circumstances have not changed significantly since inception.

⁵ In this paper, 'risk-free rate' describes a rate that discounts future cash flows for the time value of money (and for nothing else) and is consistent with observed market prices.

⁶ Incurred claims divided by earned premiums

⁷ (Incurred claims plus expenses) divided by earned premiums

21. Nevertheless, the staff believes that it is preferable to use a single measurement attribute for all types of insurance contract, without distinction. Therefore, the staff recommends no change to the Board's tentative conclusion on non-life pre-claims liabilities: These liabilities should, as the Board proposes for all insurance liabilities, be measured at current exit value. For many short-duration contracts, unearned premium may often be a reasonable approximation to current exit value, but an insurer should not 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.

Initial measurement – gains at inception

22. The trade associations recommend that no gain should be recognised on initial measurement of an insurance contract. Arguments for this position are:

- (a) The release from risk should determine the pattern of profit recognition. At inception, no release from risk has occurred. Therefore, no profit should be recognised at that point.
- (b) Measurement of insurance liabilities is inherently difficult, subjective and prone to over-optimism or manipulation. The actual premium charged to the policyholder is the only market-validated benchmark for the value of the liability at inception.
- (c) This position is consistent with IAS 39, which prohibits the recognition of gains at inception that are not evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.⁸ In practice, measurements of insurance contracts would always rely on some data that is not from observable markets.

23. Arguments against this position are as follows:

- (a) Prohibiting the recognition of gains at inception could lead (in some cases) to the reporting of deferred gains that are not liabilities. The result would not be a faithful representation of the insurer's financial position.

⁸ IAS 39 appendix A, paragraphs AG 71 and AG76 and Basis for Conclusions on IAS 39, paragraph BC98

- (b) If an insurer charges different premiums for identical obligations, a measurement calibrated to the premium will portray the obligations as different.
- (c) If the initial measurement is calibrated to the actual premium, a liability adequacy test would be needed at inception to detect cases where the liability is underpriced. For this, an insurer would need to estimate the margin that market participants would require. Although it might be possible to do this on a fairly broad brush basis if the actual premium is clearly adequate, this test would reduce the benefit of attempting to calibrate to an observed transaction price.
- (d) 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. It is inconsistent to recognise losses at inception (through a liability adequacy test) when the market is soft without recognising gains at inception when the market is hard.
- (e) If an insurer has added value by achieving higher pricing than other market participants require (eg in a niche market or if the insurer has superior distribution systems), the financial statements should report that added value.
- (f) If the initial measurement is calibrated to the actual premium, additional guidance may be needed on various items, such as the unit of account for the liability adequacy test at inception and the definition of relevant acquisition costs.

24. At the last discussion, a narrow majority (7) of the Board concluded that the observed price for the transaction with the policyholder, although useful as a reasonableness check on the initial measurement of the insurance liability, should not override an unbiased estimate of the margin another party would require if it took over the insurer's contractual rights and obligations. A large minority of the Board (6, with one abstention) concluded that the margin should be calibrated to the observed price for the transaction with the policyholder and, in consequence, that an insurer should not recognise a net gain at inception. The staff intends to draft the discussion paper on a basis that explores the arguments for both positions and summarises the narrow balance of views on the Board.

Risk margin

25. The trade associations adopt various positions in relation to risk margins:

- (a) GNAIE non-life pre-claims liabilities: the unearned premium includes the unexpired portion of the implicit profit margin that existed at inception. The liability adequacy test does not include a risk margin.
- (b) GNAIE non-life claims liability: no risk margin is included⁹
- (c) GNAIE and the Japanese life insurers: the liability measurement includes the unexpired portion of the implicit profit margin that existed at inception. ‘Margins should be changed if there is any conclusive evidence that margins are inadequate.’¹⁰
- (d) CFO Forum: the liability measurement includes the unexpired portion of the implicit profit margin that existed at inception. In addition, the liability adequacy test includes a risk margin. The CFO Forum does not specify the objective of the risk margin (for example, whether it is intended to reflect the requirements of market participants or whether some other basis is intended). The combined effect of these recommendations is that the liability is the sum of (i) the expected cash flows, discounted at a risk free-rate (ii) a risk margin and (iii) the remaining portion of the original (implicit) service margin (see paragraph 28 for more detail on that implicit service margin).

26. In the staff’s view, the proposals by the trade associations do not always provide a faithful representation of the risk and uncertainty associated with an insurance liability. The staff recommends no change to the Board’s tentative conclusion: the measurement of an insurance liability should include an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin).

Service margin

27. The Board’s tentative conclusions incorporate in the measurement of an insurance liability, in addition to the margin for the service of bearing risk (risk margin), an

⁹ Some view the omission of discounting as the inclusion of an implicit risk margin. However, that implicit margin is not related to the amount of risk inherent in the liability.

¹⁰ GNAIE and Japanese life insurers, sub-principle 6.04

unbiased estimate of the margin, if any, that market participants would require for rendering other services (service margin¹¹).

28. The trade associations do not recommend an explicit service margin. However, because they recommend no gain at inception, there would be an implicit margin equal at inception to the difference between the premium (less deferred acquisition costs) and the present value of future cash flows. For ease of discussion, this paper describes that margin as the ‘implicit profit margin’. The trade associations do not divide that margin into separate components for bearing risk and providing services, though as noted above such a division would result (under some of the proposals) from the inclusion of risk margins in a liability adequacy test.
29. The Board’s service margins and the trade association’s implicit profit margin might often lead to similar results, but the results would differ in the following respects:
- (a) At inception, the Board’s tentative conclusions lead to a gain or loss if the implicit service margin differs from the margin that market participants require. This does not happen under the trade associations’ recommendations.
 - (b) In subsequent periods, the Board’s tentative conclusions result in revenue as the insurer renders the related service and thus releases the service margin. The revenue is the margin that market participants would require, not the implicit profit margin (in this respect, the revenue differs from the revenue recognised under IAS 18 *Revenue*).
 - (c) In subsequent periods, the trade association’s implicit profit margin is released and recognised as revenue as the insurer is released from risk. The pattern of release from risk could differ from the pattern of services. For example, in some regular premium life insurance contracts, the insurer’s exposure to mortality risk could decline over the course of the contract as the investment component (and related investment services) grows.
 - (d) If it becomes apparent during the life of that contract that market participants would require a higher or lower service margin than previously estimated, the Board’s

¹¹ In previous discussions, we used the term ‘profit margin’, but we have found that people misunderstood this as a ‘plug’ to eliminate gains at inception. We are now using ‘service margin’, which describes more clearly what the Board intends.

tentative conclusions lead to an increase or decrease in the measurement of the liability. This does not happen under the trade associations' recommendations.

(e) The implicit profit margin operates to some extent as a shock absorber to absorb some adverse changes in estimates (see paragraph 47)

30. In the staff's view, it may not always be necessary to distinguish the risk margin from the service margin: the most important thing is that both should be included in the measurement of the liability. However, when the pattern of release from risk differs significantly from the pattern of services, it will be probably be necessary in practice to estimate the two margins separately.

31. The staff recommends no change to the Board's tentative conclusion: the measurement of an insurance liability, should include in addition to the margin for the service of bearing risk (risk margin), an unbiased estimate of the margin, if any, that market participants would require for rendering other services (service margin¹²)

Service margins and embedded value

32. Many life insurers in Europe (including the UK), Australia, South Africa and Canada publish embedded value information, generally as supplementary information. The CFO Forum expects that this practice will continue even when phase II is finished. Embedded value information does not include a service margin. This may ultimately become the most important difference between current exit value and the emerging new breed of 'market-consistent' embedded value.

Initial measurement – losses at inception

33. The trade associations recommend that an insurer should recognise 'economic losses' at inception, but not 'accounting losses'. A liability adequacy test would be used to detect economic losses. The economic loss would be defined broadly as follows (to highlight similarities and differences, the staff has tried to summarise the recommendations using consistent terminology, but some nuances may be lost):

¹² In previous discussions, we used the term 'profit margin', but we have found that people misunderstood this as a 'plug' to eliminate gains at inception. We are now using 'service margin', which describes more clearly what the Board intends.

- (a) For non-life, GNAIE would compare the premium (less deferred acquisition costs) with the cash flows (less estimated investment income, and with no margin added).
- (b) For life, GNAIE and the Japanese life insurers would compare the premium (less deferred acquisition costs) with the cash flows (discounted at a rate that reflects the insurer's investment strategy, with no margin¹³).
- (c) The CFO Forum would compare the premium (less deferred acquisition costs) with the cash flows (discounted at risk-free rates, with a risk margin but no service margin).

34. Under the Board's tentative conclusions, a loss would arise at inception if the premium less acquisition costs is less than the cash flows (discounted at risk-free rates, with a risk margin and, if applicable, a service margin). Therefore, two factors in the Board's model might lead to losses at inception that the trade associations view as not being 'economic losses':

- (a) The Board's tentative conclusions include both a risk margin and (if applicable) a service margin, whereas the trade associations' recommendations omit one or both of these. In the staff's view, the risk margin (and, when applicable, the service margin) portray important facets of an obligation and should not be omitted.
- (b) The Board and the CO Forum recommend risk free discount rates, whereas GNAIE and the Japanese Life insurers recommend discount rates based on the insurer's investment strategy. Paragraphs 50-53 discuss discount rates.

Measurement attribute

35. In general, the trade associations' recommendations do not explicitly specify a measurement attribute, but the implicit measurement basis could be summarised as follows:

¹³ In the recommendations by GNAIE and the Japanese life insurers, principle 2 says: 'The Net Insurance Liability at all times must be sufficient to provide for payment of all expected future obligations with adequate provision for risk and uncertainty.' This implies a risk margin is included. However, Sub-principle 4.01 says 'In the event that an insurer issued a contract on which it anticipates an ultimate loss over the term of the contract, that loss should be recognized at issue and there should be no expected gain in future years.' This implies no risk margin is included.'

- (a) GNAIE – non-life pre-claims liability: higher of (1) unearned premium and (2) unbiased best estimate of future cash flows, discounted at the estimated return on actual assets (with no risk margin).
- (b) GNAIE – non-life claims liability: unbiased best estimate of future cash flows (undiscounted, with no margins). GNAIE does not specify whether the estimate of future cash flows is a point estimate of the ultimate outcome, or an expected value that considers the full range of possible outcomes. (For life, GNAIE and the Japanese life insurers refer explicitly to expected value).
- (c) GNAIE and Japanese life insurers – life insurance: expected present value of future cash flows (discounted at the estimated return on actual assets) plus the unused portion of the implicit profit margin.
- (d) CFO Forum – life and non-life insurance: expected present value of future cash flows (discounted at the risk free rate) plus risk margin plus the unused portion of any implicit service margin. The implicit service margin is calibrated at inception to the actual premium (and acquisition costs); subsequently, that service margin is released in proportion to the release from risk (and, as explained in paragraph 47, is also reduced if it is used to absorb adverse changes in non-financial variables).
- (e) GNAIE, Japanese life insurers and CFO Forum - customer intangible assets: acquisition costs incurred, less cumulative amortisation (and less, if applicable, impairment losses recognised because of the liability adequacy test).

36. The Board has tentatively concluded that the measurement attribute for insurance should be the amount the insurer would expect to have to pay today if it transferred all its remaining contractual rights and obligations immediately to another entity ('current exit value'). An estimate of current exit value uses the following inputs:

- (a) current unbiased probability-weighted estimates of future cash flows. When market information is available (eg for interest rates or equity prices), estimates should be consistent with that data.
- (b) current market discount rates that adjust the estimated future cash flows for the time value of money.

(c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).

37. A measurement of insurance liabilities at current exit value is not intended to imply that an insurer can, will or should actually transfer the liability to a third party. Indeed, in most cases, insurers cannot transfer the liabilities to a third party and would not wish to do so. Rather, the purpose of specifying this measurement is to provide useful information that will help users make economic decisions.

Is current exit value the most useful label for the measurement attribute?

38. Because the Board has not yet reached final conclusions on the definition of fair value (in its project on fair value measurement) or current exit value (in the project on insurance contracts), the Board is not yet in position to determine whether these two notions are the same, or similar, or whether there are significant differences between them. For the time being, it is preferable to use two different phrases to avoid prejudging the outcome of both projects. If the Board concludes ultimately that the two notions are the same, the staff is likely to recommend that the Board merge them.

39. In previous discussions, we sometimes used the term current entry value to describe one possible alternative to current exit value. However, as discussed with the Board in April, in relation to insurance contracts, the staff came to view the items described by these labels as different approaches for implementing the same measurement attribute (rather than two different measurement attributes). Both approaches estimate the cash flows in the same way, use the same discount rates and require a risk margin and, if applicable, a service margin. However they place different weights on the premium as evidence of the risk margin at inception.

(a) In one approach (at one stage called current entry value), the margin would be calibrated at inception so that it is consistent with the actual premium. The argument for this approach is that this is the only directly observable calibration of the margins.

(b) In the other approach, the margin would be an unbiased estimate of the margin required by market participants. The margin implied by the actual premium might help to corroborate that estimate, but should not override that estimate.

40. In other words, what distinguishes these two approaches is the amount of weight placed on the evidence provided by the actual premium. The words ‘exit’ and ‘entry’ are not very helpful characterisations of that difference. However, constituents continue to use these terms to describe the two approaches. Therefore, it may be worth looking for a phrase other than ‘current exit value’ to describe the measurement attribute.
41. The two most important features of the measurement attribute are that it uses current inputs and that the inputs are to the (limited) extent possible consistent with observed market data. On the other hand, ‘exit’ seems to invite a distinction with ‘entry’ and the staff now views that distinction as relatively unimportant, at least in this context. Perhaps a phrase such as ‘current market-consistent value’ might be more helpful to constituents, at least at this stage of the debate.

Basis for estimates

42. The trade associations recommend that financial inputs, such as interest rates and equity prices, should be based on market information, where ‘available and reliable’. Assuming that ‘available and reliable’ means observed data should not be overridden, this position is consistent with the Board’s tentative conclusions.
43. The trade associations recommend that non-financial inputs should be based on management’s estimate. In practice, the staff believes this is generally consistent with the Board’s position because there is unlikely to be much market evidence to contradict management’s estimate. However, we think one area will remain contentious. If an insurer is much more or less efficient than other market participants, the trade association’s recommendations would require the insurer to use cash flow estimates that reflect its own efficiency, but the Board’s tentative conclusions require estimates that reflect the efficiency of market participants.¹⁴
44. In the staff’s view, the Board’s tentative conclusions appropriately exclude from the measurement cash flows that relate not to the liability itself but to synergies with other recognised or unrecognised assets or liabilities.

¹⁴ To be more complete, under the Board’s tentative conclusions, the insurer’s estimates reflect the insurer’s own strategy for determining the level of service provided to policyholders and its own approach to claims management, but the efficiency of market participants. In practice, this distinction may be difficult to make.

Review of assumptions

45. The trade associations recommend that estimates of non-financial variables should not be changed if the insurer views the revised estimates as unsustainable. However, in the staff's view, this notion is redundant in an expected value approach: if the insurer views a change in experience as unsustainable, the insurer will assign low probabilities to those scenarios in which the change persists.
46. GNAIE recommends the following:
- (a) Non-life pre-claims liabilities are measured as unearned premium, coupled with a liability adequacy test that uses current estimates to determine whether the premium is less than the expected claims payments (discounted at a rate that reflects the expected investment return, with no risk margin).
 - (b) Non-life claims liabilities are measured using current estimates.
 - (c) For life liabilities, financial assumptions are changed based on market information where available and reliable. Otherwise, financial assumptions are changed if management's best estimate of the future consistent with any relevant market information has changed and the change is expected to be sustainable and significant. Non-financial assumptions are changed if management's view of the future has changed and the changes are expected to be sustainable and significant.
47. The CFO Forum recommends the following:
- (a) Current estimates should be used for financial variables. This would avoid accounting mismatches that would arise if the assets backing the insurance contracts were measured on a basis, such as fair value, that uses current estimates for financial variables.
 - (b) Adverse changes in estimates of non-financial variables would be absorbed by the implied profit margin. Once that margin is exhausted, any further adverse change is recognised in profit and loss. (subject to a liability adequacy test)
 - (c) Favourable changes in estimates of non-financial variables would not be recognised.

48. For the following reasons, the staff does not recommend the approach described in paragraphs 46 and 47:

- (a) Users will obtain more relevant information if current estimates are used for all variables.
- (b) There may be interdependencies between financial variables (such as interest rates and equity prices) and non-financial variables (such as inflation rates, claim rates for some types of insurance or lapse rates). Also, some cash outflows depend on both financial and non-financial variables (such as minimum guaranteed death benefits for some unit-linked life insurance contracts); in such cases, arbitrary allocations may be needed to separate the effect of changes in financial variables from the effect of changes in non-financial variables.
- (c) If some changes in estimate are not recognised immediately (or are absorbed by an implicit profit margin), an insurer might measure identical obligations at different amounts, depending on how much of the implicit profit margin had been used up.

49. The staff recommends no changes to the Board's tentative conclusion: all changes (adverse and favourable) in estimates of financial and non-financial variables should be recognised immediately.

Discount rate

50. GNAIE and the Japanese life insurers (but not the CFO Forum) recommend that the discount rate for life insurance liabilities should reflect expected returns on the insurer's investment strategy (ie its actual assets). They offer the following explanation for this recommendation:

“BC30: Insurance liabilities are obligations to deliver economic resources (assets) or provide services; they are not securities. When the obligation is difficult to value or settle, it would be unreasonable to ignore attributes (i.e. the yield rates and cash flow schedule) of the assets actually dedicated to settling the obligation in the future.

BC31: Use of these rates allows the liability to move in parallel with the movement of the assets.

BC32: Use of a risk-free rate for a non-participating contract's liabilities is inconsistent with pricing methodology and with the general methodology for establishing assumptions. It also would require a reported loss for many contracts at issue, and would not be practical in countries with a limited fixed income securities

market. Companies also have very solid bases for expecting that such contracts will be profitable, and the reported losses at issue will be offset by artificially inflated subsequent reported profits.

IG5: The actual discount rate should start with either the expected earnings rate on the existing portfolio or the expected return on new local investments depending on how the supporting assets are measured. Either return should be net of investment expenses and expected defaults, if appropriate, and will have a margin for risk and uncertainty applied to it in accordance with Principle 6.

IG6: The attributes of the investment portfolio that should be used in determining a liability discount rate include:

- (a) carrying value of the assets;
- (b) expected coupon, yield and principal payment schedule,
- (c) expected default, liquidity, trading and management costs.

IG7: Where reinvestment will be required to settle claim obligations, the liability discount rate should also depend on reinvestment at a reasonable achievable rate of return.

51. The staff notes two aspects of this proposal. First, the objective of the discount rate is to adjust estimated future cash flows for the time value of money in a way that captures the characteristics of the liability, not the characteristics of the assets backing those liabilities. In the staff's view, the insurer's investment strategy is not relevant to the measurement of the liability (unless the investment cash flows affect the liability cash flows, such as for unit-linked and participating contracts). In the staff's view, this is true even if the pricing of the contract implicitly passes on to the policyholder the expected benefits of investment performance.

52. The second aspect relates to how the time value of money is defined. The term 'risk-free rate' is sometimes used as shorthand for a discount rate that the time value of money (and nothing else), and is consistent with observed market prices. Some have expressed concerns that a government bond rate is not necessarily a true risk-free rate in this sense if the government bond has liquidity characteristics that differ from those of the liability being measured. More specifically, the wrong choice of discount rate could lead to the reporting of losses at the inception of contracts that are expected to be profitable. The following extract describes the CFO Forum's recommendation for excluding factors that are not relevant to the measurement of the liability:

EP11) Certain liabilities may not be subject to particular aspects of financial risk, such as liquidity risk. In such cases, the market risk free rate should be adjusted to

reflect the absence of these risks. As a proxy for determining this adjustment, it may be appropriate to consider the yield on debt instruments with similar characteristics, such as corporate bonds. The yield should be adjusted to remove any premium for risks that are not relevant to the liability being evaluated, for example default risk.”

53. The staff recommends no change to the Board’s tentative conclusion: The discount rates should be consistent with observable market prices for cash flows whose characteristics match those of the insurance liability in terms of timing, currency and liquidity. They should exclude any factors that influence the observed rate but are not relevant to the liability (for example, risks present in the instrument used as a benchmark but not present in the liability).

Unbundling

54. The trade associations recommend that financial and non-financial components of insurance contracts should not be unbundled.
55. The staff recommends no changes to the Board’s tentative conclusions in this area:
- (a) An insurer should not unbundle insurance, deposit and service components of insurance contracts if the components are so interdependent that the components can only be measured on an arbitrary basis, but should unbundle them if such interdependencies are not present.
 - (b) The discussion paper will consider whether an insurer should unbundle deposit and insurance components for the purpose of presenting premiums and claims, but will not express a tentative conclusion.

Credit characteristics of insurance liabilities

56. The trade associations recommend that the credit standing of an insurance contract should not be considered in the valuation of insurance liabilities. We remind the Board that this view is strongly held by the vast majority of insurance professionals, including insurers, actuaries and supervisors. The Board has reviewed the arguments for and against this view several times in various contexts (eg agenda paper 4C for the May 2006 IASB meeting) and this paper does not repeat them.
57. The staff recommends no change to the Board’s tentative conclusion: The current exit value of a liability reflects its credit characteristics. An insurer should disclose any

material effect of such credit characteristics at inception and subsequent changes, if any, in their effect.

Other matters

58. In areas not covered by this paper, the staff makes no recommendation for changes to the Board's tentative conclusions.

Appendix

Interaction between measurement issues

Component	Para	Component affected	Para	Comment
Gain at inception	22-24	Margin	25-32	<p>If gains are not permitted at inception, the margin is calibrated to the premium (less acquisition costs).</p> <p>If gains are permitted at inception, the margin must be calibrated at inception to something other than the premium (though the premium would provide a reasonableness check).</p>
Gain at inception	22-24	Liability adequacy test	33 Also, 18(c) and 23(c), (d), (f)	<p>If the margin is calibrated initially to the premium (less acquisition costs), a liability adequacy test is needed at inception. That test would need to include a margin calibrated to something other than the premium.</p>

Service margin	27-33	Gain at inception	22-24	<p>If a service margin is not included (when applicable), a gain is likely to rise at inception.</p> <p>If gains at inception are prohibited, there is an implicit margin at inception.</p>
Review of assumptions	47(b)	Margin	25-32	<p>If the margin is used as a 'shock absorber' to soak up adverse changes in estimate, those changes in estimate are not recognised.</p>
Review of assumptions	45-49	Measurement attribute	35-41	<p>If some estimates are not current, requirements are needed to specify which estimates are current. This may be arbitrary, especially if different variables have interdependent effects on the cash flows. Also, it may mean that identical liabilities are measured differently</p>

AGENDA PAPER 5B Customer relationships, policyholder behaviour and acquisition costs

Purpose of this paper

1. This paper discusses:
 - (a) whether an insurer should recognise a customer relationship as an asset separate from its insurance liability, and
 - (b) whether acquisition costs incurred provide an informative measurement of (or proxy for) the customer relationship.

Summary of recommendations

2. The staff recommends no changes to the Board's existing tentative conclusions:
 - (a) Acquisition costs should be recognised as an expense, not as the cost of an asset. The recovery of acquisition costs occurs either through cash flows that have already been received or through future cash flows incorporated in the measurement of the liability. (paragraphs 3-10)
 - (b) Although the proposed measurement of an insurance liability includes some cash flows that the Board regards as relating to a customer relationship, an insurer should not present the customer relationship separately from its insurance liability. The cash flows in question are ones the policyholder must pay to retain a right to guaranteed insurability. The staff intends to ask the Board to review the guaranteed insurability test again in November in the context of universal life contracts. (paragraphs 11-28)

Separate customer intangible asset

3. The trade associations (CFO Forum, GNAIE and four Japanese life insurers) recommend that an insurer should recognise an intangible asset to reflect the initial investment made to acquire the customer relationship. They view the best proxy for the value of the customer intangible asset at inception as the initial acquisition cost arising from the contract. They define initial acquisition costs as all costs associated with procuring the insurance contract, including direct and indirect marketing and sales costs, and related overheads.

4. Under the Board's tentative conclusions, when an insurer becomes a party to an insurance contract, it should:
 - (a) recognise, in addition to its (net) contractual rights and contractual obligations, the portion of the customer relationship relating to future payments that the policyholder must make to retain a right to guaranteed insurability.
 - (b) measure that portion of the customer relationship and the related liability in the same way, and present them together.
 - (c) recognise acquisition costs (ie costs to sell, underwrite and initiate a new insurance contract) as an expense when it incurs them.
5. This paper contains two examples to illustrate the differences between the recommendations of the trade associations and the Board's tentative conclusions. Example 1 deals with a single premium contract. Example 2 deals with a regular premium contract.

Example 1 Single premium contract

6. On 1 January 20X1, an insurer issues a large number of life insurance contracts with the following features:
 - (a) Policyholders pay a premium of CU¹⁵ 12,000 on 1 January.
 - (b) The contracts are in force until 31 December 20X9. Over the ten year life of the contracts, the expected death benefits are CU 8,400. Most deaths are expected to occur in the later part of the contract term. In particular, no deaths are expected in January 20X1.
 - (c) For simplicity, the time value of money is ignored.
 - (d) The insurer incurs acquisition costs of CU 1,200 on 1 January 20X1. There are no other expenses.
 - (e) The contracts have no surrender value (ie the surrender value is zero).

¹⁵ CU = currency units

(f) The contract provides an implicit margin (for bearing risk and providing other services) of CU 2,400 (premiums of CU 12,000 less death benefits of CU 8,400 less acquisition costs of CU 1,200). Assume that other market participants would require a similar margin for identical contracts.

(g) The release from risk is assumed to be constant over the life of the contract (CU 20 per month).

(h) There are no changes in estimates during the period covered by the example (1 January 20X1 to 31 January 20X1).

7. The following table applies the trade associations' recommendations to this example. It shows the insurer's balance sheet at 1 January 2001 (after the acquisition costs and before the first premium) and 31 January 20X1 (just before the second premium), and its income statement at inception and for the next month (next month excludes inception).

Balance sheet	Note	1/1/X1	31/1/X1
Cash		10,800	10,800
Customer relationship	1	1,200	1,190
Insurance liability	2, 3	(12,000)	(11,970)
Equity		-	20

Income statement	Note	1/1/X1 inception	31/1/X1 1 month
Premiums received		12,000	-
Change in insurance liability	3	(12,000)	30
Amortisation of customer relationship	1	-	(10)
Profit		-	20

Note 1 Customer relationship	1/1/X1	31/1/X1
Opening carrying amount	-	1,200
Acquisition costs incurred	1,200	-
Amortisation	-	(10)
Closing carrying amount	1,200	1,190

Assumes a constant amount (CU10) of each monthly premium is regarded as a recovery of the customer relationship.

Note 2 Insurance liability	1/1/X1	31/1/X1
Present value of future death benefits	8,400	8,400
Margin	2,400	2,380
Sub-total	10,800	10,780
Allocation of premiums to recover customer relationship	1,200	1,190
Carrying amount	12,000	11,970

Note 3 Insurance liability: changes	1/1/X1	31/1/X1
Premium received	12,000	-
Allocation of premium to recover customer relationship		(10)
Release from risk	-	(20)
Net change	12,000	(30)
Opening carrying amount	-	12,000
Closing carrying amount	12,000	11,970

8. Next we show how the Board's tentative conclusions would apply to this example.

Balance sheet	Note	1/1/X1	31/1/X1
Cash		10,800	10,800
Insurance liability	4,5	(10,800)	(10,780)
Equity		-	20

Income statement	Note	1/1/X1 inception	31/1/X1 1 month
Gain at inception before acquisition costs		1,200	-
Acquisition costs		(1,200)	-
Net gain at inception		-	-
Premiums received		12,000	-
Change in insurance liability	5	(12,000)	20
Profit		-	20

An alternative (margin-based) presentation:

- would not show premiums as revenue or change in insurance liability as income or expense on 1/1/X1
- would label the income of CU 20 for the month ended 31/1/X1 as ‘release from risk’, rather than ‘change in liabilities’.

Note 4 Insurance liability	1/1/X1	31/1/X1
Present value of future death benefits	8,400	8,400
Margin	2,400	2,380
Carrying amount	10,800	10,780

Note 5 Insurance liability: changes	1/1/X1	31/1/X1
Gain at inception before acquisition costs	(1,200)	-
Premium received	12,000	-
Release from risk	-	(20)
Opening carrying amount	-	(10,800)
Closing carrying amount	(10,800)	(10,780)

Comments on example 1

9. Example 1 illustrates the following points:

- (a) If the pricing is in line with what market participants require, the Board's tentative conclusions and the trade association's recommendation will lead to a similar net result at inception, but they split out different assets and liabilities.
- (b) In this example, policyholders pay CU 8,400 for expected benefits plus margin of CU 2,400 (total CU 10,800), as well as CU 1,200 for acquisition costs. The presentation recommended by the trade associations:
 - (i) reports a liability of CU 12,000, even though the obligation is only CU 10,800 (expected cash flows of CU 8,400 plus margin of CU 2,400). Put differently, if the insurer could issue the same contracts incurring negligible acquisition costs, it would be willing to charge CU 10,800 for an identical liability. Similarly, a transferee incurring negligible acquisition costs would accept the liability for CU 10,800.
 - (ii) reports a customer relationship 'asset' of CU 1,200, even though the related cash flows have already been received.
 - (iii) must subsequently amortise the customer relationship 'asset' on an arbitrary basis that depends entirely on the measurement of the related liability and would not provide useful information. This demonstrates that the customer relationship 'asset' has no independent economic meaning and is simply a by-product of an over-measurement of the liability.
- (c) If the contract had a surrender value at inception equal to the premium paid (CU 12,000), there might be some rationale in measuring the liability at the surrender value of CU 12,000 and recognising a separate customer intangible of CU 1,200 (in which case, the measurement of that asset would equal the acquisition costs incurred). However, that rationale would not apply if the surrender value were any other amount, and would be difficult to apply convincingly in subsequent measurement.

10. The staff concludes that recognising a separate intangible asset measured at the amount of acquisition costs incurred would overstate the insurer's liability and report a non-existent

asset. The staff recommends that acquisition costs should be recognised as an expense, not as the cost of an asset. The recovery of acquisition costs occurs either through cash flows that have already been received (as illustrated in example 1) or through future cash flows incorporated in the measurement of the liability (as will be illustrated in example 2).

Future premiums

11. The rest of this paper considers future premiums under existing contracts. The trade associations recommend that:

- (a) policyholder behaviour including recurring premiums and lapses, should be reflected in the measurement of liabilities. Because policyholder behaviour is taken into account, they argue that no deposit floor¹⁶ is appropriate.
- (b) The cash flows included in the estimate of the insurance liability should:
 - (i) include only those associated with current insurance contracts and any existing ongoing obligation to service policyholders.
 - (ii) include the value of guarantees and renewal options that provide rights under which the policyholder can obtain a further contract on favourable terms.
 - (iii) exclude cash flows from expected renewals that are not included within current insurance contracts.

12. The Board has tentatively concluded that cash flows used in measuring the insurance liability (and related customer relationship) should include future premiums specified in the contract (and additional benefits that result from those premiums) to the extent that any of the following conditions is satisfied:

- (a) The insurer has an unconditional contractual obligation to stand ready to accept premiums whose present value is less than the present value of the resulting additional benefit payments. [The cash flows resulting from that obligation are included in the measurement of the liability]

¹⁶ The deposit floor is an informal name for the constraint that the measurement of a liability should not be less than the amount repayable (discounted from the date when repayment could be required).

- (b) The insurer has an unconditional contractual right to enforce payment of the premiums. This is not a typical case, but it does occur. [Conceptually these cash flows relate to a contractual right, but for practical reasons they would not be measured or presented separately from the cash flows included in the measurement of the liability]
- (c) The policyholder must pay the premiums to retain a right to guaranteed insurability (a right that permits continued coverage without reconfirmation of the policyholder's risk profile, at a price that is contractually constrained). [The Board has concluded tentatively that the resulting cash flows are conceptually included in the customer relationship, but for practical reasons are not measured or presented separately from the cash flows included in the measurement of the liability. The customer relationship recognised is not the entire customer relationship, but merely the portion relating to the existing contract. Future contracts and cross-selling are excluded]

13. To investigate the Board's tentative conclusions, example 2 examines a regular premium contract. The objectives are:

- (a) to show how the customer relationship is measured under the Board's tentative conclusions.
- (b) to illustrate why the Board decided tentatively not to separate the customer relationship from the insurance liability.
- (c) to demonstrate that deferred acquisition cost is unlikely to be a useful proxy for the customer relationship, either at inception or subsequently.

14. After the example, the paper comments briefly on the criteria for deciding which cash flows are included in the customer relationship.

Example 2 Regular premium contract

15. The fact pattern is the same as in example 1, with the following differences:

- (a) The premiums are CU 100 per month (CU 12,000 over the life of the contracts). To permit a clearer comparison with example 1, example 2 keeps the same total premiums and the same pattern of premiums. In a more comprehensive example, total monthly premiums would decline over the life of the contract because of death and lapses.
- (b) The insurer expects that lapses will be negligible. Also, the additional risk margin for the risk of lapses is assumed to be negligible.

16. The following table applies the Board's tentative conclusions to example 2 at 1 January 20X1 and 31 January 20X1.

Balance sheet	Note	1/1/X1	31/1/X1
Customer relationship	6, 7	1,100	1,120
Cash (overdraft)		(1,100)	(1,100)
Equity		-	20
Income statement	Note	1/1/X1	31/1/X1
		inception	1 month
Initial recognition of customer relationship		1,200	-
Acquisition costs		(1,200)	-
Net gain at inception		-	-
Premiums received		100	-
Change in customer relationship	7	(100)	-
Release from risk on customer relationship		-	20
Profit		-	20

A margin-based presentation would not show the lines labelled 'premiums received' and 'change in customer relationship'.

Note 6 Customer relationship	1/1/X1	31/1/X1
Present value of future premiums	11,900	11,900
Present value of future death benefits	(8,400)	(8,400)
Sub-total	3,500	3,500
Margin	(2,400)	(2,380)
Carrying amount	1,100	1,120

Note 7 Customer relationship: changes	1/1/X1	31/1/X1
Initial recognition of customer relationship	1,200	-
Premium received	(100)	-
Release from risk	-	20
Opening carrying amount	-	1,100
Closing carrying amount	1,100	1,120

Initial comments on example 2

17. The example shows the net cash flows the insurer expects from the contract. In the early years of the contract, the future cash flows are net inflows and so an asset is recognised. In later years, there is a net cash outflow, so a liability will be recognised. The cross-over occurs in this example when cumulative premiums received exceed (CU 1,200 plus cumulative death benefits).
18. The asset recognised incorporates expected (ie probability-weighted) lapses (assumed zero in this example), the time value of money and a risk margin for all risks, including lapse risk (the last two factors are not illustrated in this example, because of the simplified fact pattern).
19. Because no gain or loss was recognised at inception, the initial measurement of the asset (before the first premium) equals the acquisition costs.

Separating the liability from the customer relationship?

20. How would example 2 look if the customer relationship were presented separately from the insurance liability? The measurement discussed above in example 2 could be viewed as having three components:

- (a) The obligation to pay benefits if the policyholder pays no further benefits. This is made up of the surrender value (zero in this case) plus the stand-ready obligation to pay death benefits in January (nil at 31/1/X1 if all deaths are reported immediately and assumed to be, say, CU 3 at 1/1/X1, made up of expected cash flows of zero¹⁷ and a risk margin of CU 3).
- (b) The stand-ready obligation to accept further premiums during the rest of the contract term if policyholders pay additional premiums only if the present value of the additional benefits exceeds the present value of the additional premiums. For illustration, we will assume this is CU 35 at both 1/1/X1 and 31/1/X1 (made up of expected cash flows of CU 20 and risk margin of CU 15).
- (c) The customer relationship (the difference between the measurement of the whole portfolio and the two components identified in (a) and (b)).

21. With these assumptions, the balance sheet would look as follows.

Balance sheet	Note	1/1/X1	31/1/X1
Customer relationship	8, 9	1,138	1,155
Insurance liability		(38)	(35)
Customer relationship less insurance liability		<u>1,100</u>	<u>1,120</u>
Cash (overdraft)		(1,100)	(1,100)
Equity		<u>-</u>	<u>20</u>

This presentation leaves the overall measurement unchanged, but splits it into two separate components (the customer relationship and the insurance liability).

¹⁷ Strictly speaking, the expected cash flows are not zero, but are assumed to be small enough that they round to zero.

Income statement	Note	1/1/X1	31/1/X1
		inception	1 month
Initial recognition of:			
○ customer relationship		1,238	-
○ insurance liability		(38)	
Acquisition costs		(1,200)	-
Net gain at inception		-	-
Premiums received		100	-
Change in customer relationship		(100)	-
Release from risk on customer relationship	9	-	17
Release from risk on stand-ready obligation	8	-	3
Profit		-	20

A margin-based presentation would not show the lines labelled 'premiums received' and 'change in customer relationship'.

Note 8 Customer relationship	1/1/X1	31/1/X1
Present value of future premiums	11,900	11,900
Present value of future death benefits	(8,400)	(8,400)
Sub-total	3,500	3,500
Plus net cash outflows in stand-ready obligation	20	20
Margin	(2,400)	(2,380)
Add back margin in stand-ready obligation	18	15
Carrying amount	1,138	1,155

Note 9 Customer relationship: changes	1/1/X1	31/1/X1
Initial recognition (before first premium)	1,238	-
Premium received	(100)	-
Release from risk	-	17
Opening carrying amount	-	1,138
Closing carrying amount	1,138	1,155

Comments on separating the liability from the customer relationship

22. Conceptually, if the customer relationship is separated from the liability, that distinction would need to be made at the level of individual contracts because that is where the rights and obligations arise. Furthermore, a liability and a customer relationship could arise from the same contract. To determine whether an individual contract creates an obligation, it is necessary to consider the cash flows for that contract. For example, the contract may give rise to a liability in any of the following cases:
- (a) The surrender value exceeds the present value of expected future cash flows if the policyholder continues to pay premiums.
 - (b) If the policyholder continues paying premiums, the present value of the additional benefits will exceed the present value of the future premiums (perhaps because the policyholder is now in poor health).
 - (c) The policyholder is now in good health, but the option to continue paying premiums is valuable because the policyholder's health may deteriorate.
23. The insurer cannot determine which individual policyholders are in good health, because underwriting occurs only at inception. Theoretically, the insurer might be able to estimate how many contracts fall into different categories (good health / bad health etc.), but such breakdowns are likely to depend on information that is not particularly robust.
24. As example 2 shows, if the customer relationship is recognised separately from the enforceable insurance liability, the measurement of that customer relationship is unlikely to equal the acquisition costs incurred at inception. Furthermore, subsequent arbitrary amortisation of deferred acquisition costs is unlikely to be a particularly good proxy for a measurement of the customer relationship, and will not provide useful information.
25. The staff recommends that the Board retain its tentative conclusion: if cash flows pass the guaranteed insurability test, they should be incorporated in the measurement of the insurance contract. They would not be measured separately or presented separately.
26. In the staff's view, it is important to give users information about the extent to which measurements depend on cash flows that are not enforceable. However, because of the

practical difficulties involved, the staff believes that it is not viable to require a split of the measurement into enforceable and non-enforceable components. The staff plans to investigate disclosure alternatives after the discussion paper stage.

Criteria for including cash flows

27. Under the Board's tentative conclusions, future premiums (and resulting additional policyholder benefits) are included in the customer relationship (and hence in the overall measurement of the insurance contract) if the policyholder must pay the premiums to retain a right to guaranteed insurability (a right that permits continued coverage without reconfirmation of the policyholder's risk profile, at a price that is contractually constrained).
28. The trade associations propose a broader test: the premiums (and resulting benefits) are included if they are paid because of contractual rights under which the policyholder can obtain favourable terms (see paragraph 11). In the staff's view, this test includes items that pass the Board's guaranteed insurability test, but it also includes other items that do not pass the guaranteed insurability test. Examples are some regular premium annuities and some net cash inflows from universal life contracts. We plan to review the implications for universal life contracts in November.