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

International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **16 October 2006, London**

Project: **Insurance Contracts Phase II**

Subject: **Comparison of Board conclusions and industry proposals (Agenda Paper 5C)**
[Separate observer notes cover agenda papers 5-5B, 5D and 5E-F]

Purpose of this paper

1. This paper sets out a table comparing a high-level summary of proposals by some insurance trade associations with the Board's conclusions to date. Staff comments, where applicable, are set out in italics. The staff expects to recommend that a condensed version of this table be included in the discussion paper. This paper is marked up to show changes from September agenda paper 19A.

ITEM	INDUSTRY PROPOSALS*	BOARD CONCLUSIONS
1	**Separate approaches to life and non-life insurance** • GNAIE propose different principles for life and non-life insurance. • The CFO Forum propose a single model, but have yet to determine how their principles apply to reinsurance contracts.	• Single approach for all types of insurance contract (including life, non-life and reinsurance).
2	**Release From Risk** • The risk profile of a policy determines the pattern of profit recognition.	• The measurement of the liability includes a risk margin. As the insurer is released from risk, the risk margin is reduced and the insurer recognises income.
3	• For many short-duration insurance policies, the 'release from risk' approach may be closely approximated by the unearned premium approach.	• The unearned portion of the premium received may sometimes be a reasonable approximation to the required measurement if the pattern of risk is linear, the contract is not likely to be highly profitable or highly unprofitable, and circumstances have not changed significantly since inception.
4	**Initial measurement** • On initial measurement, there should be no gains or accounting losses.	• A net gain or net loss could arise at inception if the pricing is out of line with what market participants require. • If an insurer identifies an apparently significant gain or loss at inception it would need to check for errors or omissions.

* This column summarises the proposals by GNAIE, four major Japanese life insurers and the CFO Forum. In most cases, these organisations reached a common position. However, for the items marked * GNAIE's position differs in respect of non-life insurance liabilities.

ITEM	INDUSTRY PROPOSALS*	BOARD CONCLUSIONS
5	**Liability Measurement** • The liability should be based on the present value of all future cash flows with allowance for inherent risk and uncertainty.* • The cash flows should reflect management's best estimate of the future. • The best estimate should be equal to the mean estimate (probability weighted average).*	• A insurer should measure insurance liabilities at 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'). • Such an approach uses the following inputs: o 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. o current market discount rates that adjust the estimated future cash flows for the time value of money. o 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 profit margin).
6	**Discount rate** • CFO Forum: the appropriate discount rate is the risk free rate of return specific to the liabilities being measured, adjusted (if appropriate) to reflect absence of identified risk.	• 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).

ITEM	INDUSTRY PROPOSALS*	BOARD CONCLUSIONS
	• GNAIE: the discount rate for a life liability should reflect current interest rates and the company's investment strategy.	• The insurer's investment strategy is not relevant to the measurement of the liability (unless the investment cash flows affect the liability cash flows). *Staff comment: GNAIE's proposal may reflect a concern that a risk-free discount rate may lead to the recognition of losses at the inception of some contracts, such as some annuities. The extent of these concerns may depend to some extent on the exact definition of the rate that reflects the characteristics of the liability.*
	• GNAIE: discounting the post-claims non-life liability is inappropriate due to the highly unpredictable payment patterns of most claims.	• Discounting is appropriate for all insurance liabilities.

ITEM	INDUSTRY PROPOSALS*	BOARD CONCLUSIONS
7	**Separate Customer Intangible Asset** • An intangible asset should be recognized to reflect the initial investment made to acquire the customer relationship. • The best proxy for the value of the customer intangible asset at inception should be the initial acquisition cost arising from the contract. • Initial acquisition costs represent all costs associated with procuring the insurance contract, including direct and indirect marketing and sales costs, and related overheads.	• When an insurer becomes a party to an insurance contract, it should: o 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. o measure that portion of the customer relationship and the related liability in the same way, and present them together. • An insurer should recognise acquisition costs (ie costs to sell, underwrite and initiate a new insurance contract) as an expense when it incurs them. *Staff comments:* • *If the pricing and acquisition costs are in line with what is typical for market participants, applying the Board's tentative conclusions the initial measurement of the liability (together with the related portion of the customer relationship) is approximately the same as the net result, under the industry's proposals, of measuring the liability less the intangible asset.* • *If the recognised portion of the customer relationship (applying the Board's tentative conclusions) is measured and presented separately, its initial measurement is unlikely to equal the acquisition costs incurred.* • *The industry's proposals would mean that subsequent receipts of recurring premiums would need to be allocated between the intangible asset and the liability. In the staff's view, any such allocation would be arbitrary and would not provide useful information.*

ITEM	INDUSTRY PROPOSALS*	BOARD CONCLUSIONS
8	**Review of Assumptions** • Assumptions underlying the measurement of insurance liabilities and intangible assets should be periodically reviewed and updated as appropriate. • This review should consider relevant market information and management's best estimate of the future.	• The Board's conclusions on liability measurement require current estimates at measurement date. *Staff comment: the industry proposals do not require changes in assumptions that management does not expect to be sustainable. In the staff's view, this is implicit in the use of unbiased estimates of the probabilities of each scenario, but there may be some difference of emphasis between the industry's proposals and the Board's tentative conclusions.*
	• CFO Forum: o Changes in financial assumptions are recognised immediately; o For pre-claims liabilities, the implicit profit margin[1] (if any) absorbs adverse changes in non-financial assumptions, and favourable changes in non-financial assumptions are not recognised.	• All changes are recognised immediately, for both financial and non-financial variables.
	• GNAIE: Non-life pre-claims liabilities are measured as unearned premium, coupled with a liability adequacy test that uses current assumptions.	• All changes are recognised immediately.

[1] The staff is using the term 'implicit profit margin' here to describe the additional margin (above the risk margin) that is needed to avoid recognising a gain at inception.

ITEM	INDUSTRY PROPOSALS*	BOARD CONCLUSIONS

9	**Unit of Account**
	• Measurement should be on a portfolio basis.
		• ~~To be discussed by the Board in September.~~Risk margins:
		  • should be determined for a portfolio of insurance contracts that are subject to broadly similar risks and managed together as a single portfolio.
		  ~~(c)~~• should not reflect benefits, if any, of diversification between portfolios and negative correlation between portfolios.

10	**Policyholder Behaviour**
	• Policyholder behaviour including recurring premiums and lapses, should be reflected in the measurement of liabilities. Because policyholder behaviour is taken into account, no deposit floor is appropriate.
	• The cash flows included in the estimate of the insurance liability should:
	  o include only those associated with current insurance contracts and any existing ongoing obligation to service policyholders.
	  o include the value of guarantees and renewal options that provide rights under which the policyholder can obtain a further contract on favourable terms.
	  o exclude cash flows from expected renewals that are not included within current insurance contracts.
		• The cash flows used in measuring the insurance liability 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:
		  o 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.
		  o The insurer has an unconditional contractual right to enforce payment of the premiums. This is not a typical case, but it does occur.
		  o 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).
		
		Under the Board's tentative conclusions, some net cash inflows from some existing contracts (eg regular premium annuities and some net cash inflows universal life contracts) may not qualify for inclusion in the measurement of the liability.

ITEM	INDUSTRY PROPOSALS*	BOARD CONCLUSIONS
11	**Options and Guarantees** • Options and guarantees should be included in the measurement of the liability reflecting both their time value and intrinsic value.	• Implied by the current exit value approach
12	**Unbundling** • No unbundling of underlying financial and non-financial components of insurance contracts.	• For the purpose of recognition and measurement, insurers: ○ ~~insurers need~~ should not unbundle deposit and service components of insurance contracts if the components are so interdependent that the components can be measured only on an arbitrary basis. ○ ~~the Board has not yet discussed whether unbundling should be prohibited in some cases.~~ should unbundle the components if such interdependencies are not present. • 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.
13	**Own Credit Risk** • The credit standing of an insurance contract should not be considered in the valuation of insurance liabilities.	• 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.

ITEM	INDUSTRY PROPOSALS*	BOARD CONCLUSIONS
14	**Asset and Liability Consistency** • Entities should measure assets and liabilities on a consistent basis to reflect the way companies manage risk.*****	• The Board does not expect this project to change existing IFRSs (eg IAS 39) for assets held by insurers (except possibly in some cases where the liability cash flows are contractually determined by the assets). • In general, under the Board's tentative conclusions, insurance liabilities and related assets will be measured on a consistent basis if the assets are measured at fair value through profit or loss
	• Where the value of the insurance liability is linked, contractually or through other legal or regulatory terms, to the value of associated assets, the value of the insurance liabilities is calculated with reference to the market value of the assets at the valuation date.	• Current exit value of these linked liabilities will reflect the fair value of the assets to which they are linked. • There may be an accounting mismatch if the linked assets are not carried at fair value through profit or loss (eg treasury shares, owner occupied property, subsidiary held by unit linked fund). The discussion paper will review possible ways of eliminating this mismatch, but not express a tentative conclusion.
15	**Participating contracts** These principles apply equally to participating contracts. • Liabilities should include the best estimate of future policyholder benefits (dividends, bonuses, etc.) • The best estimate of future policyholder benefits should be based on the other assumptions used to estimate liabilities. • Amounts that are expected to be paid to policyholders should therefore not be included in equity.	• Policyholder participation rights create a liability when the insurer has an unconditional obligation that compels the insurer to transfer economic benefits to current or future policyholders. *Staff comment: In some cases, the insurer may expect to pay policyholder dividends, but not yet have an unconditional obligation (or it may not be clear whether there is an unconditional obligation). In this case, the policyholder participation right is a liability under the industry proposals, but a component of equity under the Board's tentative conclusions. Further discussion due in ~~September~~October.*