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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

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Project: Insurance Contracts, Phase II

Subject: Project update from IASB website (Agenda Paper 5D)

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Insurance Contracts (Phase II)

Project Updates are provided for the information and convenience of constituents who wish to follow the IASB's deliberations. All conclusions reported are tentative and may be changed at future IASB meetings. Decisions become final only after completion of a formal ballot to issue an International Financial Reporting Standard, Interpretation, or Exposure Draft.

Introduction

This project report is structured as follows:

- Objective
- Next steps
- Background
- Tentative conclusions to date
- Contact information

Objective

1. The objective of this project is to develop an IFRS on accounting for insurance contracts. The project will address accounting by both insurers and policyholders.

Next Steps

2. The Board is working towards a Discussion Paper.

3. If there are no unexpected delays, the staff estimates that the discussion paper will be published in the first quarter of 2006. An exposure draft will take at least 18 months from then, and a final standard will take at least another 12 months.

4. The Board expects to discuss the project in October 2006. Meetings of the Board and of the Insurance Working Group are open to the public:

- See www.iasb.org for registration details and agendas.
- Click here for observer notes for IASB meetings.
- Click here for observer notes for meetings of the Insurance Working Group.

Background

Introduction

5. This project summary addresses phase II of the Board's project on insurance contracts. The Board completed phase I in March 2004 by issuing IFRS 4 *Insurance Contracts*.

- Click here for a summary of IFRS 4.
- Click here for frequently asked questions on the content and development of IFRS 4.

6. The Board suspended work on phase II in early 2003, and restarted phase II in mid 2004.

7. In restarting phase II, the Board is taking a fresh look at financial reporting by insurers. Past work by the Board and by its predecessor is a useful resource, but the Board does not feel bound by it. The only restrictions on a fresh look are the IASB's conceptual framework and the general principles established in the IASB's existing Standards. Similarly, the Board can learn from national or industry practice, but will not be constrained by it.

8. To advise it on the project, the Board formed an Insurance Working Group, made up of senior financial executives, analysts, actuaries, auditors and regulators. Click here for a list of participants. The Insurance Working Group has held eight two-day meetings, starting in September 2004. The most recent meeting was in June 2006.

9. In January 2005, the IASB reviewed a project plan. Click here for the plan.

10. There are important interactions with other projects, particularly those on the conceptual framework, revenue recognition, accounting measurement, performance reporting, financial instruments and revisions to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and a potential project on liabilities and equity. The work on insurance contracts will proceed in parallel with these other projects and will not wait for their outcome. This work may generate useful inputs for those other projects.

Convergence

11. An important priority for the IASB is seeking convergence with national standards, especially US GAAP. The US Financial Accounting Standard Board (FASB) plans to issue an Invitation to Comment containing the IASB discussion paper. The FASB will consider the responses in deciding whether to add to its agenda a joint project with

the IASB to develop a comprehensive standard on accounting for insurance contracts.

12. Some current and recent FASB projects address limited aspects of accounting for insurance contracts:

- In its project on risk transfer in insurance and reinsurance contracts, the FASB is developing a definition of insurance contracts and exploring simplified approaches to bifurcating insurance contracts. In May 2006, the FASB published an *Invitation to Comment on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*. The IASB staff currently expects that the IASB's Discussion Paper:
    - will consider whether some or all insurance contracts should be unbundled (bifurcated). IFRS 4 requires unbundling in some cases and permits, but does not require, it in others.
    - will not review the IASB's existing definition of an insurance contract in IFRS 4 and related guidance. The IASB staff does not view work on this definition as a high priority. Nevertheless, the staff will monitor the FASB's work in this area and assess the implications for phase II.
- The FASB is reviewing the measurement of financial guarantee insurance contracts. The IASB staff will monitor the FASB's work in this area.
- In March 2006, the FASB issued an FASB staff position on *Accounting for Life Settlement Contracts by Third-Party Investors*. A life settlement occurs when an individual sells his or her life insurance contract to a third party who intends to continue paying the premiums on the contract. Although the scope of the IASB's project includes accounting by holders of insurance contracts (including both the original policyholder and a transferee), the staff expects that the IASB will not address this topic until after the discussion paper.

Tentative Conclusions to Date

13. The following paragraphs summarise the preliminary conclusions that the Board expects to include in the Discussion Paper:

- Recognition and derecognition (paragraphs 14 and 15)
- Measurement (paragraphs 16-22)
- Why does the IASB prefer a current value approach (paragraph 23)?
- Current estimates of future cash flows (paragraphs 24-28)
- Discount rates (paragraph 29)
- Estimating the margin (paragraphs 30 and 31)
- Portfolio basis of measurement (paragraphs 32 and 33)
- Future premiums and policyholder behaviour (paragraphs 34-36)
- Policyholder participation rights (paragraph 37)

- Universal life contracts (paragraph 38)
- Reinsurance assets (paragraph 39)
- Unearned premium – can it be a reasonable approximation to current exit value (paragraph 40)?
- Acquisition costs (paragraphs 41 and 42)
- Assets held by insurers (paragraph 43-46)
- Changes in insurance liabilities (paragraph 47)
- Investment contracts (paragraph 48)

Recognition and derecognition

14. An insurer should recognise rights and obligations created by an insurance contract when it becomes a party to the contract.

15. An insurer should derecognise an insurance liability (or a part of an insurance liability) when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.

Measurement

16. An insurer should use the following inputs to measure its insurance liabilities:

    - current unbiased probability-weighted estimates of future cash flows. (discussed further in paragraphs 24-28)
    - current market discount rates that adjust the estimated future cash flows for the time value of money. (discussed further in paragraph 29)
    - 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). (discussed further in paragraphs 30 and 31)

17. A concise name for a measurement that uses those three inputs is ‘current exit value’. Current exit value is 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.

18. Typically, the current exit value of an insurance liability is not observable, so it must be estimated using the three inputs described above.

19. It is too early to conclude whether current exit value is synonymous with fair value. The Board will review that question as work proceeds on the Board’s fair value measurement project.

20. 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.

21. For the purpose of recognition and measurement, an insurer should not unbundle insurance, deposit and service components of insurance contracts if the components

are so interdependent that the components can be measured only on an arbitrary basis, but should unbundle them if such interdependencies are not present. In relation to presentation, the discussion paper will discuss, without expressing a preliminary view at this stage, whether an insurer should:

- present all premiums as revenue, all premiums as deposit receipts, or some premiums as revenue and some premiums as deposit receipts.
- split premiums for some or all insurance contracts into a revenue component and a deposit component.

22. 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.

Why does the IASB prefer a current value approach?

23. In the Board's view, a current value approach for insurance liabilities will provide several benefits to users of an insurer's financial statements:

- more relevant information about the amount, timing and uncertainty of future cash flows arising from existing insurance contracts. Given the uncertainty associated with insurance liabilities and the long duration of many insurance contracts, such information is particularly important.
- a more consistent approach to favourable changes in estimates. In most existing approaches, some favourable changes are recognised implicitly by offset against other changes that are adverse. Thus, these existing approaches recognise favourable changes arbitrarily, depending on whether other adverse changes occur at the same time and on the size of implicit margins that existed at inception.
- a more coherent framework to resolve emerging issues without resorting to unprincipled distinctions and arbitrary new rules.
- consistency with other IFRSs that already require current estimates of future cash flows in measuring non-financial liabilities (see IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) and financial liabilities (see IAS 39 *Financial Instruments: Recognition and Measurement*).
- less (and perhaps no) need to separate embedded derivatives.
- less (and perhaps no) need for anti-abuse rules to prevent selective recognition of previously unrecognised economic gains through reinsurance.
- less (and perhaps no) need for arbitrary criteria to distinguish amendments to an existing contract (with unchanged estimates and an unchanged discount rate, in a cost-based approach) from new contracts (with new estimates and a new discount rate).
- margins that are explicit rather than implicit.
- clearer reporting of economic mismatches between insurance liabilities and related assets.

Current estimates of future cash flows

24. The need to estimate future cash flows would not be completely new. Insurers already use estimates of future cash flows for some aspects of many existing accounting approaches and many insurers already use cash flow estimates as one factor in pricing decisions. Nevertheless, a current value approach places more demands on estimates of cash flows than most existing approaches, particularly in longer duration contracts. This is because changes in estimated cash flows affect profit or loss immediately in a current value approach, but may do so only over time in some existing approaches.

25. Commentators sometimes object to proposals for current estimates on the grounds that it is not useful to require immediate adjustment of all estimates to be identical to the most recent actual experience. However, these objections are based on a misunderstanding. For example, suppose that mortality experience last year was 20 per cent worse than previous experience and previous expectations. Several factors could have caused the sudden change in experience, including:

- lasting changes in mortality
- changes in the characteristics of the insured population (eg changes in underwriting or distribution, or selective lapses by policyholders in unusually good or bad health)
- random fluctuations
- identifiable non-recurring causes.

26. An insurer would typically investigate the reasons for the change in experience and develop new probability estimates for each possible outcome, in the light of the most recent experience, earlier experience and other information. Typically, the result would be that the expected present value of the cash flows increases, but not by as much as 20%. Actuaries have developed various ‘credibility’ techniques that an insurer could use in assessing the impact of new evidence on the probability of different outcomes. In this example, if mortality continues to run significantly above previous estimates, the insurer would increase over time the estimated probability assigned to high-mortality scenarios.

27. Estimates of the probabilities for each scenario should faithfully represent conditions at the reporting date. However, it is also important to consider whether changes in estimates faithfully represent changes in conditions during the period. For example, if estimates were at one end of a reasonable range at the beginning of the period and conditions have not changed, moving to the other end of the range would not faithfully represent what has happened during the period.

28. To the extent possible, estimates should be consistent with observed market prices:

- Some estimates relate to observable market variables, such as interest rates. An entity should use these variables as direct inputs without adjustment.
- Other estimates relate to variables (such as mortality) that cannot, in general, be observed directly from market prices and transactions. These estimates:
    - should be reviewed every year and should be updated if they are no longer consistent with all available current information about conditions at the reporting date.

- should not contradict observable market variables. For example, an assumption about future inflation rates should be within a range that is consistent with expectations implied by market interest rates.

Discount rates

29. 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. It 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).

Estimating the margin

30. As explained above, one input to be used in measuring an insurance liability is a margin. Several Board members believe 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.

31. However, a majority of Board members believe 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.

Portfolio basis of measurement

32. In principle, the expected (probability-weighted) cash flows from a portfolio equal the sum of the expected cash flows of the individual contracts. Therefore, the unit of measurement does not affect the expected present value of future cash flows. Moreover, unbiased estimates of cash flows reflect all relevant inputs, regardless of whether those inputs are derived contract by contract or in aggregate.

33. 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. Risk margins should not reflect benefits, if any, of diversification between portfolios and of negative correlation between portfolios.

Future premiums and policyholder behaviour

34. One right associated with some insurance contracts is the right to collect future premiums specified in the contract. The cash flows used in measuring the insurance liability should include those future premiums (and additional benefits that result from those premiums) to the extent that any of the following conditions is satisfied:

    - 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 insurer has an unconditional contractual right to enforce payment of the premiums. This is not a typical case, but it does occur.

    - 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).

35. The rights and obligations discussed in the first two bullets of paragraph 34 are clearly part of the insurer's contractual rights and contractual obligations, and it is clear that they must be included in the measurement of the insurance liability.

36. The case discussed in the third bullet of paragraph 34 is more problematic. In that case, the insurer does not have a contractual right to collect the premiums because the insurer cannot enforce their payment. However, there is a customer relationship (the relationship with the policyholder), which the insurer should treat as follows:

- When the insurer becomes a party to the contract, the insurer should recognise the portion of that customer relationship that relates to future payments that the policyholder must make to retain a right to guaranteed insurability.

- The insurer should measure that portion of the customer relationship and the related liability in the same way, and should present them together. Although the customer relationship is conceptually separate from the contractual rights and contractual obligations, separate recognition and measurement would be impracticable and, arguably, not useful.

- The measurement of the liability should exclude the effects of premiums that do not meet the conditions in paragraph 34.

Policyholder participation rights

37. Policyholder participation rights create a liability when the insurer has an unconditional obligation that compels the insurer to transfer economic benefits to policyholders, current or future. The economic benefits transferred may take several forms, including cash and additional insurance cover. More specifically:

- If participating policyholders have a prior claim on distributions of economic benefits generated by a pool of contracts and related assets, that fact does not, by itself, oblige the insurer to transfer those benefits to policyholders. Therefore, an insurer should not recognise that prior claim as a liability, unless some other factor creates an obligation.

- A dividend scale approved by the regulator creates an obligation. The staff will investigate whether the insurer should measure that obligation using the dividend scale currently in force, or develop estimates of the dividend scale that would apply in each cash flow scenario.

- To the extent that no unconditional obligation exists, an insurer should not recognise a liability in respect of expected transfers of economic benefits to policyholders. If an unconditional obligation comes into existence subsequently, the insurer should recognise the resulting liability and an expense at that time.

- In assessing whether an insurer has a constructive obligation to pay dividends to participating policyholders, the Board will rely on the definitions being developed in its conceptual framework and IAS 37 projects. The Board decided tentatively in February 2006 that an equitable or constructive obligation can be a liability only if it legally or equivalently compels potential outflows of cash or other economic resources. An obligation may be enforceable in various ways, including legal action or intervention by a regulator. However, economic compulsion is not sufficient to create an enforceable obligation.

- Policyholder participation rights should not be regarded as the equity component of a hybrid contract (similar to convertible debt). Accordingly, no part of the premium should be regarded as proceeds received for issuing an equity instrument. Moreover, the face of the income statement need not distinguish profit or loss attributable to equity holders of the insurer and profit or loss subject to prior claims of policyholders. However, the insurer should disclose the fact that part of its equity is subject to those prior claims.

- Identical requirements should apply to shareholder-owned insurers and mutuals.

- Participation rights in investment contracts should be treated in the same way as participation rights in insurance contracts.

- The staff will investigate whether the face of the balance sheet should distinguish equity attributable to policyholders from equity attributable to shareholders, and whether the face of the income statement should distinguish profit or loss attributable to policyholders from profit or loss attributable to shareholders.

Universal life contracts

38. Universal life insurance contracts allow the policyholder to vary premiums, subject to specified minimums and maximums and allow the insurer to vary charges to policyholders within specified limits. The Board has discussed these contracts, focusing on the proposed test for including future premiums (ie guaranteed insurability), the classification (as a liability or as equity) of crediting rates that exceed the minimum that can be contractually required and the interaction of crediting rates with estimates of lapses. The staff will investigate these issues further.

Reinsurance assets

39. Reinsurance assets should be measured at current exit value. Among other things, that measurement incorporates a reduction for the expected (probability-weighted) present value of losses from default or disputes, with a further reduction for the margin that market participants would require to compensate them for bearing the risk that defaults or disputes exceed expected value (an expected loss model).

Unearned premium – can it be a reasonable approximation to current exit value?

40. When an insurer enters into an insurance contract, it takes on an obligation to stand ready to pay valid claims for future insured events arising under the existing contract. Many existing models for non-life insurance measure that obligation by reference to the unearned portion of the premium received. That approach may sometimes provide a reasonable approximation to a current value approach 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.

Acquisition costs

41. Insurers incur costs to sell, underwrite, and initiate a new insurance contract (acquisition costs). An insurer should recognise acquisition costs as an expense when it incurs them.

42. Acquisition costs play no direct role in determining current exit value. However, they might play an indirect role as one piece of evidence that might help to corroborate estimates of the price that market participants might be prepared to receive (or pay)

for the insurer's contractual rights and contractual obligations and for the portion of the customer relationship that relates to the existing contract.

Assets held by insurers

43. 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, as discussed in paragraphs 41-43).

Assets held by insurers: Unit-linked contracts

44. Some contracts link the benefit amount directly to the fair value of a designated pool of assets operated in a way similar to a mutual fund. The Board has considered whether there are circumstances in which an insurer:

- should not recognise those assets, and the related part of the obligation to pay policyholder benefits, or
- should recognise those assets and the related part of the obligation, but should present those assets as a single line item, separate from the insurer's other assets.

45. The Board has also discussed the effects on profit or loss and equity that arise if the pool of assets includes investments that are not measured at fair value through profit or loss. In the Board's view, it would be preferable to eliminate such effects, but eliminating them might create inconsistencies with other requirements of IFRSs. The Board has discussed several alternatives to address this concern, including an adjustment to the measurement of the assets or the related part of the obligation and the recognition of items (such as treasury shares or internally generated goodwill) that would not qualify for recognition as assets in other circumstances. The Board noted that these effects do not occur if the insurer does not recognise the assets and the related part of the obligation. The Board decided that the discussion paper should review the alternatives, but not express a preliminary view on these matters.

Assets held by insurers: Index-linked contracts

46. Some contracts link the benefit amount directly to an index but do not require the issuer to hold the assets underlying the index. There is an effect on profit or loss if the issuer holds the underlying assets and does not measure them at fair value through profit or loss. The Board has decided tentatively not to introduce exceptions to normal recognition and measurement criteria for those assets or the related liabilities.

Changes in insurance liabilities

47. The discussion paper will discuss the components of changes in insurance liabilities and discuss in general terms approaches to presenting and disclosing them, but will not propose specific requirements for presenting and disclosing those changes. The project on presentation of financial statements will be relevant.

Investment contracts

48. Many insurers issue some contracts that are within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* because they do not transfer significant insurance risk. The discussion paper will document the differences between the Board's tentative conclusions for insurance contracts and existing requirements in IAS 39 and IAS 18 *Revenue*. The discussion paper will present the Board's

preliminary view that it would be preferable to eliminate those differences, but will not propose specific methods for doing so.

Contact information

49. Staff contact

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