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International Accounting Standards Board

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Note: These notes are based on the staff paper prepared for the Financial Instruments Working Group Meetings. Paragraph numbers correspond to paragraph numbers used in the Financial Instruments paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB Meeting:	**Financial Instruments Working Group**
Paper:	**Agenda Paper 7**

Insurance contracts

Purpose of this paper

1. In the next few weeks, the Board will publish a discussion paper on insurance contracts. The objective of this session is to update members of the working group on that project, focussing on differences between the Board's preliminary views on insurance contracts and existing requirements for financial instruments in IAS 39.

2. The appendix to this agenda paper contains a late draft of a summary of the preliminary views that the Board will express in the discussion paper.

3. Agenda paper 7A summarises some differences between the Board's preliminary views for insurance contracts and existing requirements in IAS 39.

Appendix
Summary of preliminary views

(extract from a late draft of the discussion paper on insurance contracts)

Scope (chapter 1)

IN13. This paper deals with insurance liabilities (an insurer's obligations under an insurance contract) and insurance assets (an insurer's rights under an insurance contract).

IN14. This paper does not discuss accounting by policyholders for insurance contracts. The Board plans to address that topic later in this project.

What is an insurance contract?

IN15. IFRS 4 defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.' This paper does not discuss whether that definition is still appropriate. The Board plans to consider that question in developing an exposure draft.

IN16. The preliminary views in this paper apply to all types of insurance contract: life and non-life, direct insurance and reinsurance. They also apply throughout the life of a contract, to both the pre-claims period (ie the coverage period when the insurer is standing ready to meet valid claims) and the claims period (when the insured events have occurred but the ultimate payment is still uncertain).

Recognition and derecognition (chapter 2)

IN17. An insurer should recognise rights and obligations created by an insurance contract when it becomes a party to the contract. An insurer should derecognise an insurance liability (or a part of an insurance liability) when it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires. Because derecognition of financial assets is a complex topic and the subject of another project, the discussion paper does not address derecognition of insurance assets.

Measurement – core issues (chapter 3)

IN18. The Board's preliminary view is that an insurer should measure all its insurance liabilities using the following three building blocks:

(a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows.

(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).

IN19. Several Board members believe the margin should be calibrated to the observed price for the transaction with the policyholder. In consequence, an insurer would never recognise a profit at inception. However, a majority of Board members believe the observed price for the transaction with the policyholder, although important 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.

IN20. In the Board's view, a measurement using the three building blocks will provide several benefits to users of an insurer's financial statements:

(a) relevant information about the amount, timing and uncertainty of future cash flows arising from existing insurance contracts.

(b) explicit and more robust estimates of cash flows and margins.

(c) a consistent approach to changes in estimates.

(d) an appropriate and consistent approach for all types of insurance (and reinsurance) contracts. This will:

(i) provide a coherent framework to deal with more complex contracts (such as multi-year, multi-line or stop loss contracts) and to resolve emerging issues without resorting to unprincipled distinctions and arbitrary new rules.

(ii) limit the need for arbitrary rules on such matters as embedded derivatives, financial reinsurance, and amendments to existing contracts.

(e) consistency with other IFRSs that require current estimates of future cash flows in measuring financial and non-financial liabilities.

(f) clearer reporting of economic mismatches between insurance liabilities and related assets, and a reduction in accounting mismatches.

(g) consistency with observable current market prices, to the extent they are available. Such prices provide an understandable and credible benchmark for users, even though market prices are not available to support all inputs used in measuring insurance liabilities.

IN21. An informative and concise name for a measurement that uses the three building blocks is ‘current exit value’. This paper defines current exit value as the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity.

IN22. A measurement at current exit value is not intended to imply that an insurer can, will or should transfer its insurance liabilities 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 objective is to provide useful information that will help users make economic decisions.

Policyholder behaviour, customer relationships and acquisition costs (chapter 4)

IN23. An insurer has an asset relating to its ability to derive net economic benefits from future premiums that the policyholder must pay to retain guaranteed insurability. Guaranteed insurability is a right that permits continued coverage without reconfirmation of the policyholder’s risk profile and at a price that is contractually constrained.

IN24. The insurer should recognise that asset, and measure it in the same way as the related insurance liability (ie at current exit value). That asset is part of a customer relationship, not a contractual asset. Nevertheless, the insurer should present that asset as part of the related insurance liability. The insurer need not separate that asset from the liability for recognition, measurement or presentation. Thus, measurement of the insurance liability would be based on estimated cash flows from both that asset and the liability.

IN25. Some Board members disagree with the preliminary views summarised in paragraphs IN23 and IN24:

(a) Some of them believe that an insurer should not recognise net economic benefits expected from future premiums if the insurer cannot compel the policyholder to pay those premiums.

(b) Some of them believe that the criterion of guaranteed insurability is open to inconsistent application and abuse. For this reason, and for reasons discussed in chapter 3, they would prohibit the recognition of a profit at the inception of an insurance contract. In their view, an insurer should recognise a customer relationship asset, measured at inception at the amount of acquisition costs incurred, to the extent those costs are recoverable.

(c) Some of them believe that an insurer should always present the recognised part of a customer relationship separately from an insurance liability.

IN26. An insurer should recognise acquisition costs as an expense when it incurs them. If the insurer expects to recover acquisition costs from future premiums that policyholders must pay to retain guaranteed insurability, those premiums reduce the measurement of the liability because the insurer includes them in the recognised part of the customer relationship. If the insurer recovers acquisition costs from premiums already received, receiving that part of those premiums does not increase the measurement of the liability.

Measurement – other issues (chapter 5)

Assets held by insurers

IN27. In this project, the Board does not intend to change existing IFRSs (eg IAS 39 *Financial Instruments: Recognition and Measurement*) for assets held by insurers, except possibly for some assets relating to unit-linked contracts.

Unit of account

IN28. Risk margins should be determined for a portfolio of insurance contracts that are subject to broadly similar risks and are managed together as a single portfolio. Risk margins should not reflect the benefits of diversification between portfolios and negative correlation between portfolios.

Reinsurance assets

IN29. A cedant should measure reinsurance assets at current exit value. For risks associated with the underlying insurance contract, a risk margin typically increases the measurement of the reinsurance asset and equals the risk margin for the corresponding part of the underlying insurance contract. The current exit value of reinsurance assets 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 for bearing the risk that defaults or disputes exceed the expected value.

Splitting contracts into their components (unbundling)

IN30. Some insurance contracts contain both an insurance component and a deposit component. An insurer should treat these contracts as follows:

(a) if the components are so interdependent that the components can be measured only on an arbitrary basis, the phase II standard on insurance contracts should apply to the whole contract.

(b) if the components are not interdependent, the phase II standard should apply to the insurance component and IAS 39 should apply to the deposit component.

(c) if the components are interdependent but can be measured separately on a basis that is not arbitrary, IAS 39 should apply to the deposit component. The whole contract would be measured by applying the phase II standard. Consequently, the insurance component would be measured as the difference between the measurement of the whole contract and the measurement of the deposit component.

Credit characteristics of insurance liabilities

IN31. The current exit value of a liability is the price for a transfer that neither improves nor impairs its credit characteristics. An insurer should disclose the effect of such credit characteristics at inception and subsequent changes, if any, in their effect. In practice, such effects are normally small.

Investment contracts

IN32. Many insurers and reinsurers issue both insurance contracts and contracts that do not transfer significant insurance risk (investment contracts). Investment contracts are within the scope of IAS 39 and, in some cases, IAS 18 *Revenue*. Appendix B summarises differences between existing requirements in IAS 39 and IAS 18 and the Board's preliminary views on insurance contracts. In principle, the Board would prefer to eliminate those differences. However, the Board has not yet assessed whether that will be feasible. Thus, this paper includes no specific proposals for such contracts.

Policyholder participation (chapter 6)

IN33. As already noted, one building block used in measuring an insurance liability is estimates of the cash flows in each scenario. To the extent that a legal or constructive obligation exists at the reporting date, the estimated cash flows for each scenario should include an unbiased estimate of the policyholder dividends resulting from that obligation. An insurer would need to consider the guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether such an obligation exists. Such an obligation may arise when the insurer becomes a party to the participating contract, but that will depend on the facts of each case. The Board plans to finalise in 2008 a revised version of IAS 37, building on an exposure draft of 2005.

IN34. In measuring a participating liability contract at current exit value, an insurer should measure asset-dependent cash flows on a basis consistent with the measurement of the underlying assets. The insurer should use option-pricing techniques that capture, on a market-consistent basis, both the intrinsic value and time value of the asymmetric pay-offs resulting from the participation feature.

IN35. These preliminary views apply equally to participating insurance contracts and participating investment contracts. They apply to participating contracts issued by both shareholder-owned insurers and mutuals.

IN36. For universal life contracts, estimates of crediting rates in each scenario should reflect the rate that the insurer estimates it would pay in that scenario to satisfy a legal or constructive obligation that exists at the reporting date.

IN37. For unit-linked contracts, benefits depend partly on the fair value of a designated pool of assets. Accounting mismatches could arise if those assets are not measured at fair value through profit or loss but the related liability is measured at current exit value. The Board would prefer to eliminate those mismatches, but has not yet formed a preliminary view on whether this is appropriate. Nor has it yet formed a preliminary view on the recognition and presentation of those assets.

IN38. For index-linked contracts, the insurer is not compelled to hold the underlying assets and it could transfer the liability without a simultaneous transfer of the assets. Existing requirements in IFRSs remain appropriate for assets held to back index-linked contracts.

Changes in insurance liabilities (chapter 7)

IN39. Profit or loss should include all changes in the carrying amount of insurance liabilities.

IN40. In developing an exposure draft, the Board will consider whether an insurer should present premiums as revenue or as deposit receipts, and whether the face of an insurer's income statement should present separately specified components of the changes in the carrying amount of insurance liabilities. The Board has not yet formed a preliminary view on these topics.