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**International Accounting Standards Board**

*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*
*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:** **21 February 2007, London**

**Project:** **Insurance Contracts (phase II)**

**Subject:** **Sweep issues - substantive issues in Board members' comments on pre-ballot draft (agenda paper 11B)**

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| | *Board member comment* | *Staff response* |
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| 1 | **Measurement attribute** | |
| (a) | The cover memo for the pre-ballot draft expressed the staff's view that the most important features of the measurement attribute selected by the Board are the use of current information and the use to the maximum (albeit limited) extent possible of market data. The staff recommended retaining the label 'current exit value' for this measurement attribute., rather than possible alternatives, such as:<br>o 'current exit price'<br>o 'market-consistent current value'<br>One Board member prefers 'current exit price'. | Retain 'current exit value'. |
| (b) | Explain in more detail how current exit value differs from fair value. | Appendix E to the pre-ballot draft includes a brief summary of some features of FAS 157. The relevant paragraphs are appended to this paper. In the staff's view, a more detailed comparison would not be particularly helpful. |

| | *Board member comment* | *Staff response* |
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| 2 | **Cash flow estimates**<br>Paragraphs 29 and 30 of chapter 3 (see appendix to this paper) discuss how cash flow estimates should deal with costs of administering contracts. They distinguish an entity's strategy for servicing the contracts (included in current exit value) from the entity's own efficiency in delivering that servicing. Board members had various comments: | |
| | o Should expenses reflect the strategy that other market participants would use, rather than the insurer's own strategy? | Arguably, reflecting a different strategy would measure a different liability, not the liability the insurer actually has. Moreover, the strategy used will affect not just the costs of administering the contracts, but all the other cash flows, through the effect on, for example, lapses and claim costs. Attempting to identify which strategy other market participants will use is likely to be highly speculative. It would also require the insurer to make cash flow estimates that it would make for no other purpose and would not use internally for risk management. That is unlikely to enhance their reliability. |

| | *Board member comment* | *Staff response* |
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| | o How can the insurer separate the strategy from the efficiency? | The staff views the process as follows. If an insurer concludes that its expenses are out of line with the market:<br>o Assess whether the difference arises from strategy or efficiency.<br>o If the difference arises mainly from strategy, the estimates would reflect the insurer's strategy.<br>o If the difference arises mainly from efficiency, the estimates would use the insurer's estimate of the efficiency of market participants.<br>o If the difference arises to a material extent from both strategy and efficiency, the insurer would need to identify their respective effects (which may be difficult).<br>The important point is that not all differences in expense levels are due to efficiency, some are due to strategy. |
| | o What is the market reference? Suppose most of the market is inefficient but there are some efficient players. | The need to identify a market reference is inherent in any approach that refers to the estimates that market participants would make.<br>The staff does not intend to develop further guidance for inclusion in the discussion paper. |

| | *Board member comment* | *Staff response* |
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| | o Why are future expenses included at all? | The insurer has a stand-ready obligation to service the contract, and will incur these expenses in doing so. Any market participant would consider these expenses (to the extent they are not entity-specific). |
| 3 | **Risk margins**<br>Give more guidance on how to determine risk margins. | Appendix C contains a working draft of guidance on risk margins, in the context of the discussion in chapter 3. The staff does not believe it would be productive to develop or refine that guidance at this stage. The responses will help us assess whether more or different guidance will be useful. In addition, the Risk Margin Working Group of the International Actuarial Association is developing materials on risk margins (and cash flow estimates). The (IASB) staff expects that Group's work to produce further insights over the next few months. |

| | *Board member comment* | *Staff response* |
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| 4 | **Interaction with revenue project**<br>Paragraphs 80-82 of chapter 3 discuss the allocated customer consideration approach that has been discussed in the revenue project.  Paragraph 82 states:  "In the Board's view, the allocated customer consideration approach is unlikely to be suitable for insurance liabilities unless that approach is developed in a way that involves explicit current estimates of the cash flows, the time value of money and explicit margins for risk and, if applicable, other services."  When was this discussed by the Board? | The Board has not discussed this conclusion explicitly in this form. In the staff's view, it is implicit in the Board's discussion of various alternatives during this project. |

| | *Board member comment* | *Staff response* |
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| 5 | **Customer relationship**<br>Paragraph 11(e) of chapter 4 states: "A customer relationship meets the definition of an asset, and is accordingly recognised as an asset if acquired separately or in a business combination."<br>o The paper should explain why a customer relationship meets the definition of an asset, because this is not universally agreed.<br>o The paper should explain better why this particular customer relationship is recognised, when others are not. | Customer relationships are recognised as an asset in a business combination. This implies that they are assets. Therefore, there must be other reasons why internally generated customer relationships are not recognised. Thus, it would not be productive to include a discussion of why they are assets. Instead, the discussion focuses on whether they should be recognised in particular cases, and whether they should be combined with the related insurance liability.<br>Although some Board members disagree with the Board's conclusions in this area, the staff believes that further discussion of the conclusions would not be productive at this stage. The staff will work to improve the drafting of the discussion in this area. |

| | *Board member comment* | *Staff response* |
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| 6 | **Universal life contracts**<br>Paragraph 32 of chapter 6 states: “However, in the Board’s preliminary view, a measurement based solely on the contractually guaranteed minimum crediting rate is unlikely to provide useful information for users. Instead, estimates of crediting rates in each scenario should reflect what the insurer actually expects to do in that scenario, not the absolute minimum that can be contractually required.”<br>Is this what the Board agreed? The cash flows should reflect the contractual obligation, not what is expected. | In the staff’s view, this is what the Board agreed (in line with the staff recommendation). Update for January 2006 said: “The Board tentatively decided that each cash flow scenario used in measuring a universal life contract should include interest credited at the rate that the insurer estimates will apply in that scenario, rather than the contractually required minimum.” |
| 7 | **Premiums**<br>Chapter 7 discusses (among other things) whether insurers should treat premiums as revenue or as deposits. The chapter notes that the Board has not yet formed a preliminary view on this issue.<br>The Board should decide on such a basic issue. | The paper contains a discussion of the issues. In the staff’s view, we will be better placed to come back to this issue when we have feedback from readers of the discussion paper. We will also benefit from further developments in the project on presentation of financial statements. |

| | *Board member comment* | *Staff response* |
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| 8 | **Premiums and acquisition costs**<br>In July 2006, the Board reviewed the presentation of the income that arises when the initial premium received exceeds the initial measurement of the insurance liability. The Board decided tentatively that this income is revenue, rather than a gain.<br>The staff points out that the pre-ballot draft does not discuss this conclusion.<br>Some Board members believe that existing revenue recognition criteria are not met at inception. | In the staff's view, it would be inconsistent to deal with this detailed issue, given that chapter 7 (changes in insurance liabilities) does not express preliminary views on more basic issues. |
| 9 | **Comment deadline**<br>In the cover memo, the staff suggested a comment period of 180 days.  No Board members objected. | |

**Appendix**
**Extracts from pre-ballot draft**

**Extract from Appendix E**

E5. The objective of the IASB's project on fair value measurement is to simplify IFRSs and improve the quality of fair value information included in financial reports. The project will not introduce new measurements at fair value. In November 2006, the Board published a discussion paper *Fair Value Measurements*. The deadline for comments is 4 May 2007. The paper seeks views on whether the IASB should develop a concise definition of fair value and a single source of guidance for all fair value measurements required by IFRSs. The starting point for the Board's discussions was a recent US standard, SFAS 157 *Fair Value Measurements*.

E6. Some important features of SFAS 157 follow:

(a) Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

(b) A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.

(c) Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

(i) independent of the reporting entity; that is, they are not related parties

(ii) knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary

(iii) able to transact for the asset or liability

(iv) willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

(d) Fair value is based on the assumptions that market participants would use in pricing the asset or liability.

(e) Valuation techniques used to measure fair value should maximise the use of observable inputs and minimise the use of unobservable inputs. Observable inputs reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. Unobservable inputs reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

(f) In many cases, the fair value of an asset or liability at initial recognition (an exit price) equals the price paid or received (an entry price), but there is no presumption that they are equal.

E7. Because the IASB has not yet reached final conclusions on the definitions of fair value for IFRSs (in the FVM project) and current exit value (in the project on insurance contracts), the IASB cannot yet determine whether these two notions are the same, or similar, or whether there are significant differences between them.

**Extract from chapter 3**

29. The above paragraphs distinguish entity-specific cash flows from the cash flows that would arise for other market participants. That distinction is most likely to be significant for the expenses associated with administering insurance contracts during their life. Here, it is worth distinguishing two aspects of future expense levels:

(a) The insurer's strategy for determining the level of service provided to policyholders and its approach to claims management. This will have a pervasive effect on the insurer's expense levels, lapse and claim rates because of the implications for the level of service and for claims handling procedures. For example, an insurer that has aggressive, but expensive, claims management will have low claims rates but high expense levels. Similarly, the level and type of service might affect the degree of adverse selection caused by selective lapsation by policyholders with different risk characteristics. The Board's preliminary view is that estimates of cash flows should reflect the insurer's chosen strategy for determining the level of service provided to policyholders and its approach to claims management. It would be neither informative nor practicable to estimate the cash flows on a different basis.

(b) The insurer's efficiency in providing that level of service and implementing its selected approach to claims management. Some argue that the insurer should estimate cash flows based on its own level of efficiency; supporters of this view believe that such estimates will be useful to users because they reflect the cash flows that the insurer expects to occur, rather than hypothetical cash flows that would occur only in the extremely unlikely event that the insurer transfers the liability to another party. However, this approach would incorporate in the measurement cash flows that relate not to the liability itself but to synergies with other recognised or unrecognised assets or liabilities; therefore, the Board's preliminary view is that the measurement of the liability should be based on the efficiency of market participants, not the insurer's own efficiency.

30. In practice, it may be difficult to distinguish clearly the insurer's expense and servicing strategy from its efficiency in implementing that strategy. Therefore, the Board expects that an insurer would use estimates of its expenses, unless there is clear evidence that the insurer is significantly more or less efficient than other market participants.