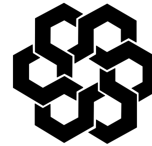

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International Accounting Standards Board

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

Note: These notes are based on the staff paper prepared for the Council. Paragraph numbers correspond to paragraph numbers used in the Council paper.

INFORMATION FOR OBSERVERS

SAC Meeting: **November, London**

Project: **Insurance contracts**
(Agenda Paper 7)

Purpose of this paper

1. In May 2007, the Board issued a discussion paper *Preliminary Views on Insurance Contracts*. The comment deadline is 16 November 2007. This paper discusses the following issues relating to the discussion paper:

   (a) background and scope (paragraphs 2-6)

   (b) basic measurement model (paragraphs 7-18)

   (c) significant challenges (paragraphs 19-27)

   (d) convergence with US GAAP (paragraphs 28-30)

   (e) policyholder accounting (paragraph 31)

   (f) questions for SAC members (paragraphs 32-35)

Background and scope

2. The objective of this project is to develop an IFRS on accounting for insurance contracts.

3. The Board completed phase I of this project in 2004 by issuing IFRS 4 *Insurance Contracts*. The Board's objectives for phase I were to make limited improvements to accounting practices for insurance contracts, to avoid requiring major changes that phase II might reverse and to require insurers to disclose information about insurance contracts. For several reasons, permitting IFRS 4 to remain in place indefinitely is not a viable option:

   (a) IFRS 4 permits too much diversity in practice. It permits many practices that are not suited to providing relevant and reliable information to users.

   (b) Some of those practices have developed in a piecemeal fashion over many years and do not provide a coherent framework for resolving emerging issues or coping with new types of insurance contract.

   (c) In some cases, accounting for insurance contracts has been heavily influenced by supervisory concerns. This has sometimes resulted in methods that do not distinguish clearly between an accounting question (What assets and liabilities does the insurer have?) and a management and supervisory question (What assets should an insurer hold to give sufficient assurance of satisfying its existing obligations?).

   (d) Some existing practices are inconsistent with practices used by other entities, particularly other financial institutions, such as banks and fund managers. These inconsistencies impede comparisons between insurers and other financial institutions. They can also mean that financial conglomerates produce financial statements that are internally inconsistent.

4. There are important interactions with other projects, particularly those on the conceptual framework, revenue recognition, accounting measurement, performance reporting, financial instruments, revisions to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and liabilities and equity. The Board expects that 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.

5. The Board does not expect this project to change existing IFRSs (eg IAS 39 *Financial Instruments: Recognition and Measurement*) for assets held by insurers (except possibly in some cases where the liability cash flows are contractually determined by the assets).

6. Many insurers issue some contracts that are within the scope of IAS 39 because they do not transfer significant insurance risk. The discussion paper documents differences between the Board's preliminary views for insurance contracts and existing requirements in IAS 39 and IAS 18 *Revenue*. The discussion paper presents the Board's preliminary view that it would be preferable to eliminate those differences, but does not propose specific methods for doing so.

Basic measurement model

7. The Board has reached the preliminary view that an insurer should use the following inputs (building blocks) to measure its insurance liabilities:

   (a) current unbiased probability-weighted estimates of future cash flows. (discussed further in paragraphs 9-11)

   (b) current market discount rates that adjust the estimated future cash flows for the time value of money. (discussed further in paragraph 12)

   (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). (discussed further in paragraphs 13 and 14)

8. After discussing these building blocks, this section summarises the advantages of using them (paragraph 15) and then considers how to define a measurement attribute that includes those building blocks (paragraphs 16-18).

Current estimates of future cash flows

9. The starting point for the measurement is an estimate of the cash flows. Many models now use a point estimate of one single outcome, for example the most likely outcome or an outcome that is 'sufficient' at some implicit or explicit level of confidence. However, a measurement of an insurance liability is most useful if it captures the full range of possible outcomes and their probabilities. Therefore, in the Board's preliminary view, the starting point for the measurement should be an estimate of the expected present value of the cash flows (ie the probability-weighted average of their present value).

10. It seems widely accepted that insurers should estimate cash flows for non-life claims liabilities using all currently available information. However, there are two main

approaches to estimating cash flows for life insurance contracts and during the pre-claims period of non-life contracts. One approach makes estimates at inception and locks them in permanently, unless the insurer needs to recognise a loss because of a liability adequacy test. The Board favours the other approach, one that uses all currently available information (but not just the most recent actual experience).

11. The Board believes that estimates of cash flows should, as far as possible, be consistent with observable market prices. Thus, an insurer would use observable current market prices (for example, current prices of equity securities), and other observable market variables (such as interest rates) as direct inputs without adjustment. For other variables (eg frequency and severity of claims), an insurer would consider all available data, external and internal, but the estimates should not contradict current market variables. For example, estimates of future general inflation would need to be consistent with expectations implied by market interest rates.

Discount rates

12. It is uncontroversial that life insurance liabilities should reflect the time value of money. However, there is less agreement about non-life insurance liabilities, especially those long-tail liabilities that are subject to the greatest uncertainty. Some argue that discounting such liabilities would introduce too much subjectivity and would not pass a cost-benefit test. However, in the Board's preliminary view, the time value of money is relevant for all insurance liabilities, including nonlife claims liabilities. The discount rate would correspond to the pure time value of money, and would not depend on the actual assets held unless the cash flows from the assets affect the cash flows from the liabilities, as for some participating contracts).

Estimating the margin

13. A liability with fixed cash flows is not the same as a liability with uncertain cash flows. To represent that difference faithfully, the measurement of a liability would include an explicit and unbiased estimate of the margin that market participants require for the service of bearing risk (risk margin) and, if applicable, rendering other services, such as investment management (service margin).

14. Several Board members believe those margins should be calibrated to the observed price for the transaction with the policyholder. Thus, an insurer would never recognise a net gain at inception. However, a majority of Board members believe the observed price for the transaction with the policyholder, although an important check on the reasonableness of the initial measurement, should not override an unbiased estimate of the margin another party would require for the contractual rights and obligations.

Advantages of using these building blocks

15. In the Board's view, a measurement using those 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, based on explicit and more robust estimates of cash flows and margins.

    (b) A consistent approach to changes in estimates.

    (c) A coherent framework to resolve emerging issues without resorting to unprincipled distinctions, arbitrary new rules and anti-abuse requirements.

    (d) 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*).

    (e) Consistency, with observable current market prices, to the extent available. This will provide an understandable and credible benchmark for users.

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

Describing the measurement attribute

16. The measurement that results from using those three building blocks will be most helpful to users if it is not merely the result of a computation but represents faithfully a real economic attribute of the insurance liability and can be described briefly and informatively. In the Board's preliminary view, an informative and concise name is

‘current exit value’. A working definition of current exit value is the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. Because current exit value is not typically observable, it must be estimated using the three building blocks.

17. The Board has not yet reached final conclusions on the definition of fair value (in its project on fair value measurements) or current exit value (in the project on insurance contracts). Therefore, the Board is not yet in a position to determine whether these two notions are the same. However, the Board has not so far identified significant differences between them.

18. Is current exit value relevant if, as is usually the case, an insurer does not intend (and cannot) transfer the liability to another party? When a transferee determines an acceptable price to take on an insurance liability, it would consider the ultimate cash flows to the policyholder. Therefore, current exit value reflects those cash flows. Thus, current exit value provides useful information that will help users make economic decisions, whether or not the insurer intends to transfer the liability.

Significant challenges

19. The following paragraphs discuss some significant challenges that face any accounting model for insurance contracts:

    (a) Future premiums and policyholder behaviour (paragraphs 20-23)

    (b) Policyholder participation rights (paragraphs 24-26)

    (c) Changes in insurance liabilities (paragraph 27)

Future premiums and policyholder behaviour

20. For many regular premium contracts, the policyholder can cancel the contract before paying all premiums. For some groups of policyholders, the payment of extra premiums will result in extra net cash outflows from the insurer (for example, for groups of life policyholders with severely impaired health). There is no doubt that the measurement of the insurance liability needs to include the extra net cash outflows that will result.

21. However, in other cases, the insurer wants policyholders to continue paying premiums because, in aggregate, the result is beneficial to the insurer. This is typically the case in the early years of many life insurance contracts. These cases are more problematic. The insurer expects most policyholders to continue paying. Policyholders also expect to continue paying, unless their circumstances change. Otherwise, the policyholder probably bought the wrong product. Nevertheless, the insurer cannot compel the policyholder to continue paying premiums.

22. The Board has reached the following conclusions in this area:

    (a) The insurer has an asset relating to the future premiums that the policyholder must make to retain a right to guaranteed insurability (less additional benefits that result from those premiums). Guaranteed insurability refers to a right that permits continued coverage without reconfirmation of the policyholder's risk profile, at a price that is contractually constrained.

    (b) Conceptually, that asset is best viewed as a portion of a customer relationship, not as a contractual right.

    (c) When the insurer becomes a party to the contract, the insurer should recognise that portion of the customer relationship (but not the rest of the customer relationship relating to future contracts).

    (d) 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.

23. Many do not understand why we have struggled so much with this issue. In their view, the solution is simply to include all the cash flows that result from the contract, taking into account estimates of policyholder behaviour. However, that 'solution' would need to specify that the cash flows are ones that result from substantive rights and obligations in the contract. The only plausible test is one that relies on the fact that the insurer has a pricing commitment – and that would lead us straight back to the apparent paradox that an insurer recognises a larger asset as a result of taking on an extra obligation.

Policyholder participation rights

24. Participating (with profits) contracts permit the policyholder to benefit from favourable performance of a group of contracts and/or related assets. The insurer has some discretion over whether, how and when the benefits are allocated to policyholders collectively and as individuals, but there are often constraints over that discretion. There is a huge variety of types of participation, and in many cases the constraints on the insurer's discretion may not have been tested.

25. The key accounting issue is whether the insurer has an obligation to pay those benefits, or whether the policyholders' interest is an unusual form of equity interest. The Board's preliminary view is that the policyholders' participation right is not a liability unless the insurer has a legal or constructive obligation. Mere economic compulsion (must pay bonuses to stay competitive in the market) does not make a liability. Moreover, the fact that policyholders may have a collective prior claim on the surplus does not, in itself, make an obligation.

26. The Board's preliminary view is unpopular with some who argue that the liability measurement should include all cash flows that are generated by existing assets and liabilities and are expected to go to policyholders. (It is not clear to the staff that this approach could be applied identically to mutuals and to stockholder insurers.)

Changes in insurance liabilities

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

Convergence with US GAAP

28. The project is not part of the Memorandum of Understanding between the IASB and the FASB. The Boards have been treating it as a 'modified joint project', led initially by the IASB.

29. In August, the FASB issued an Invitation to Comment *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB* Discussion Paper, Preliminary Views on Insurance Contracts. This asks respondents to

comment on whether the FASB should add to its agenda a joint project on insurance contracts, to be conducted with the IASB.

30. The FASB's comment deadline is 16 November 2007. The FASB expects to discuss comments received on its Invitation to Comment and on the IASB's Discussion Paper at an Insurance Forum in March or April of 2008 and to make an agenda decision in the third quarter of 2008.

Policyholder accounting

31. In this project, the Board intends to address accounting by both insurers and policyholders. However, because the Board does not view work on policyholder accounting as a high priority, the discussion paper does not address it. The staff will ask the Board in the fourth quarter of 2007 whether a separate discussion paper is needed on policyholder accounting, or whether it would be sufficient to go straight to an exposure draft. The Board has not yet discussed whether a single standard should cover both insurer accounting and policyholder accounting, or whether two standards will be needed.

QUESTIONS FOR SAC MEMBERS

32. Do you have any comments on the three building blocks used in the basic measurement model proposed in the discussion paper?

33. Is 'current exit value' the best description of a measurement that uses those three building blocks?

34. Do you have any comments on:

    (a) Future premiums and policyholder behaviour?

    (b) Policyholder participation rights?

    (c) Presentation of changes in insurance liabilities?

35. Do you have any concerns about how policyholders account under IFRSs for insurance contracts they hold (policyholder accounting)?