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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IASB Meeting: **Insurance Working Group, April 2008**
Paper: **Settlement value (Agenda paper 3)**

Purpose of this paper

1. Several respondents advocate a measurement that reflects the fact that the insurer intends (and in most cases must) settle the liability by paying the policy benefits as they fall due, rather than by transferring the liability to a third party. Some respondents use 'settlement value' or similar terms to describe this notion. This paper considers:

   (a) whether settlement value might be a candidate to be a measurement attribute for insurance liabilities.

   (b) how settlement value might be defined.

2. The issues discussed in this paper might be relevant for several projects:

   (a) Insurance contracts

   (b) Fair value measurements

   (c) Non-financial liabilities (the project to amend IAS 37)

   (d) Revenue

(e) Conceptual framework (measurement phase)

3. The rest of this paper deals with the following subjects:

   (a) What did the Discussion Paper propose and what did respondents say (paragraphs 4-10)?

   (b) What does settlement value not mean (paragraphs 11-18)?

   (c) What could settlement value mean (paragraphs 19-23)

   (d) Do we really need to define a measurement attribute? (paragraph 24)

   (e) Next steps in the project on insurance contracts (paragraphs 25-27)

   (f) Questions for participants (paragraphs 28 and 29)

What did the Discussion Paper propose and what did respondents say?

4. The discussion paper proposed that insurers should measure insurance liabilities at current exit value. In other words, the measurement attribute for insurance liabilities would be current exit value. (Assets and liabilities have various economic 'attributes', such as cost and fair value. We select one of those attributes to be used as the measurement that appears in the financial statements. That attribute is called the 'measurement attribute'. Most accounting models used today – not just for insurers, but for all entities - are 'mixed attribute' models. In other words, they select different measurement attributes for different assets and liabilities.)

5. Because current exit value would rarely, if ever, be observable, it would be estimated using three building blocks:

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

   (b) Current market discount rates that adjust the 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)

6. In very general terms, respondents largely support the three building blocks, but there is significant opposition to current exit value, largely for the following reasons:

   (a) Respondents do not view current exit value as relevant if an entity cannot actually transfer the liability.

   (b) Current exit value excludes entity-specific cash flows. Most respondents believe that the most relevant measure of the liability uses the expenses that the insurer expects to incur in administering the liability, not the expenses that a market participant would incur. Paragraph 8 expands on this point.

   (c) The current exit value of a liability reflects its credit characteristics. Unsurprisingly, most respondents reject this notion, particularly if it leads to income or expense when the liability is remeasured.

7. Respondents had some other concerns about current exit value (and the building blocks) and we intend to discuss these concerns separately, but this paper does not discuss them because they do not seem to provide much insight at this stage into whether some form of settlement value might be a relevant measurement attribute:

   (a) Whether gains should be recognised at inception. Views are mixed on this.

   (b) How risk margins should be determined in practice.

   (c) The meaning of service margins.

   (d) Discounting for non-life claims liabilities (but see paragraph 12).

   (e) The structure of the performance statement.

   (f) (1) Policyholder behaviour and (2) policyholder dividends. These are two important topics and we will discuss them separately. However, in the staff's view, these topics relate mainly to defining what thing is being measured, rather than establishing what the measurement attribute should be for that thing. There is no obvious reason to reach one conclusion on these topics if the measurement attribute is current exit value and a different conclusion if the measurement attribute is some form of settlement value. Thus, this paper does not discuss these two topics.

8. As noted above, many respondents objected to the exclusion of entity-specific cash flows. More specifically:

   (a) The discussion paper proposed that estimates of cash flows should be consistent with the cash flows that market participants would face. Respondents generally agreed with this to the extent that cash flows are determined by observable financial market prices, such as interest rates and traded equity prices.

   (b) The discussion paper also argued that, in practice, market participant cash flows relating to underlying insurance claims would not differ from the corresponding entity-specific cash flows. It seemed that most respondents accepted this argument, at least implicitly.

   (c) Many respondents objected to using estimates of the 'expenses' that market participants would incur, rather than entity-specify 'expenses'. In this context, 'expenses' refers to the costs of administering insurance contracts during their lives, rather than the cost of the underlying claims. Respondents put forward the following arguments:

      (i) Given that most insurance liabilities will not, and cannot, be transferred, entity-specific expenses are more relevant to users than the expenses that market participants would incur.

      (ii) It is often not possible to observe directly what expenses market participants would incur. Moreover, any apparent differences between those expenses and entity-specific expenses may arise from subtle and perhaps undetectable differences between the portfolios of, and products provided by the entity, and the product and portfolios of other market participants. Thus, estimates of market participants' expenses may be less robust than the entity's estimates of its own expenses.

      (iii) It may be difficult to persuade auditors and regulators that the insurer has done enough work to confirm that its expenses are in line with those incurred by other market participants.

(iv) Insurers price by reference to their own expected cash flows. Thus, a measurement based on market-participant cash flows could lead to a gain or loss at inception. This would reverse in later periods as the insurer provides the services.

9. Some respondents oppose current exit value without making a serious attempt to define a more appropriate measurement attribute. However, a fair number of respondents advocate a measurement that reflects the fact that the insurer intends (and in most cases must) settle the liability by paying the policy benefits as they fall due, rather than by transferring the liability to a third party. Some respondents use ‘settlement value’ or something similar to describe this notion, though no response gives anything like a rigorous definition of settlement value. Suggestions included

   (a) Current ultimate settlement value

   (b) Current performance value

   (c) Current extinguishment value

   (d) Current value assuming an orderly settlement of the rights and obligations over time by the reporting entity

   (e) Entity-specific ultimate settlement value, defined as the present value of the amount that would be required to meet the contractual obligations to policyholders in the ordinary course of business over time, including an entity-specific required margin to perform the tasks necessary to settle the obligation.

10. The following paragraphs discuss what respondents do **not** intend the settlement value notion to mean (paragraphs 11-18). They then assess what respondents **do** intend it to mean (paragraphs 19-23).

What does settlement value not mean?

11. Based on respondents’ comments, it seems that respondents generally do not intend settlement value to mean any of the following:

   (a) Undiscounted estimate of the ultimate cash flows, with no margin (paragraph 12)

(b) Discounted estimate of the ultimate cash flows, with no margin (paragraph 13)

(c) Surrender value (paragraphs 14 and 15)

(d) Commutation value (paragraph 16-18)

Undiscounted estimate of the ultimate cash flows, with no margin

12. Non-life (property and casualty) insurers today typically measure claims liabilities at an undiscounted estimate of the ultimate cash flows, with no margin (or at least, no explicit margin). Some non-life insurers advocate that this should continue. However, this basis is probably best viewed as something distinct from the settlement value notion intended by many respondents. So this paper does not discuss this basis further. We will discuss that basis separately.

Discounted estimate of the ultimate cash flows, with no margin

13. Respondents generally accept that the measurement of a liability should include a margin (although, as noted above, some non-life insurers would exclude a margin if discounting is also excluded). In this respect, respondents differ from some respondents to the exposure draft on non-financial liabilities (issued in 2005 as a proposal to amend IAS 37), because some of them believe that IAS 37 should not require a margin.

Surrender value

14. Some insurance contracts contain a surrender value. In other words, the policyholder can cancel the policy and receive a refund. No-one advocates measuring insurance contracts at surrender value. In many circumstances, the surrender value is far below the value of the contract to both the policyholder and the insurer. This is most easily seen in a single-premium contract if the surrender value is zero. In that case, the policyholder will give up something valuable on cancellation (the right to continued insurance coverage) and gain nothing in return. Measuring that insurer's liability at zero is unlikely to provide relevant information to users.

15. Some (including some Board members) would use the surrender value as a floor. In other words, the measurement of the liability could exceed the surrender value, but could never be lower. Respondents do not generally advocate a surrender value floor.

Commutation value

16. Sometimes, insurers and policyholders negotiate a termination of an existing contract. Such a transaction is known as a commutation. This may occur for a variety of reasons, including changes in the policyholder's needs, avoiding sub-economic-scale processing costs in the later stages of a group or reinsurance contract and concerns about the insurer's solvency. Commutations occur in the reinsurance and large commercial markets. They are unlikely in retail markets because the transaction costs would be prohibitive.

17. In some respects, a commutation value is similar to current exit value. In negotiating a price for the commutation, both parties (insurer and policyholder) would consider the cash flows, time value of money and uncertainty (and resulting margin). However, unlike current exit value, a commutation value would reflect a negotiation between two participants only (the existing insurer and the existing policyholder) and would not reflect views of other market participants. Moreover, commutations are arguably not between two willing parties. Typically, they are initiated because one of the parties has some compelling incentive to initiate a renegotiation that was not previously expected.

18. Most respondents opposed current exit value because in most cases the exit transaction is not likely to occur (and is generally not even possible). Similarly, commutations are rare. Thus, it seems unlikely that most respondents would favour commutation value as the measurement attribute.

What could settlement value mean?

19. As already noted, respondents who favoured some form of settlement value did not define very clearly what they intended. In general terms, they seem to want something that is actually quite similar to current exit value as described in the discussion paper, but modified to:

    (a) have a slightly more entity-specific flavour. More specifically, estimates of expenses (ie the costs of administering the contracts) would reflect the insurer's own expectations, systems and efficiencies. Conversely, estimates of cash flows related to financial market variables (such as interest rates and equity prices) would be market-consistent. Furthermore, as already noted, in relation to the costs of the underlying insurance claims, the discussion paper argued that there would be no difference in practice between entity-specific estimates and the entity's own estimate of market participants' estimates. In summary, market-consistent cash flows would be distinct from entity-specific cash flows for some cash flows only, namely the costs of administering the contracts.

(b) exclude the credit characteristics of the liability.

20. The measurement attribute respondents are looking for seems to be something like the following:

> The economic burden to the insurer of its obligation to pay contractual benefits as they fall due. [This wording attempts to capture what we believe respondents had in mind. It is not a quote from the responses.]

21. This tentative description is neither rigorous nor succinct. It also leaves open several questions, so arbitrary rules might be needed to answer them:

(a) What is the precise basis for deciding which cash flow are included? Respondents seem generally happy with using market observable financial market data where it exists, but it is not totally clear how a mix of market-consistent and entity-specific inputs can be resolved into a single coherent measurement attribute (except when entity-specific inputs are used as the best available evidence of market-consistent inputs, or vice versa).

(b) What is the margin intended to convey? For current exit value, the objective of the margin is reasonably clear – it is the amount market participants would require (though practical implementation poses many problems)

(c) Would gains be permitted at initial recognition?

(d) Would the credit characteristics of the liability affect its measurement? Most respondents would say no, but it is not obvious how the tentative description answers that question without an additional, arbitrary stipulation.

22. We have not investigated in detail whether we can identify a measurement attribute that corresponds to what respondents seem to be looking for. The possibilities we could consider might include the following:

    (a) The estimated price for transferring the liability to another insurer that is identical in all respects to the insurer itself (a mirror image insurer). This approach would deal with one concern raised by respondents, because it would pick up entity-specific cash flows. However, our initial analysis suggests it may not overcome the other two concerns expressed by respondents: (1) many believe it is not relevant to consider transfer if transfer is not likely; (2) many oppose the inclusion of credit characteristics.

    (b) The amount the insurer would rationally pay at the reporting date to settle the liability with the policyholder or to transfer it to another insurer. This could be described as the lower of (i) the amount the insurer would have to pay to induce the policyholder to break the contract [described earlier in this paper as commutation value] and (ii) the amount the insurer would have to pay to induce a third party (ie another insurer) to accept the liability. The Board tentatively decided in February 2008 to adopt as similar approach in the project to amend IAS 37, dealing with non-financial liabilities. In reaching that conclusion, the Board noted that there is not a market for most liabilities within the scope of IAS 37 and hence entities would have to estimate the amount that a third party would demand to take over an obligation. The Board tentatively decided to emphasise that, in such circumstances, the calculations (1) should assume the third party has the same information as the entity about the obligations and (2) would be based on the entity's own estimates of the future cash flows required to discharge the obligation (adjusted if there is evidence that a third party's cash flows would be different).

    (c) Other possibilities, yet to be identified.

23. If entity-specific cash flows are included, arguably the measurement captures something more than just an attribute of the liability itself but also includes synergies between the liability and other assets (such as goodwill). Thus, arguably, including entity-specific cash flows does not change the measurement attribute but rather it changes the thing being measured (the unit of measurement).

Do we really need to define a measurement attribute?

24. Does it matter whether we can define settlement value in a rigorous and concise way? Would it be sufficient to list the building blocks to be used, without trying to come up with a single all-encompassing summary description of what the result means? There are three reasons why it is preferable to try to identify a consistent measurement attribute that can be described concisely:

    (a) A clearly described measurement attribute provides a coherent framework to resolve new and emerging issues. Conversely, if separate building blocks are selected with no underlying coherent principle, they are likely to conflict with each other in some cases and so arbitrary rules may be needed to deal with emerging issues.

    (b) It should be easier to communicate with users with a concise and easily understandable measurement attribute, rather than a disparate collection of building blocks that may have no unifying theme.

    (c) The measurement phase of the conceptual framework project may well conclude that measurements should always aim to be a faithful representation of some real-world economic attribute of the item being measured. An assembly of disparate building blocks may not meet that need.

Next steps in the project on insurance contracts

25. Given the weight of support in the comment letters for something like a settlement value notion, we intend to consider whether it is a serious candidate for selection as the measurement attribute. However, so far we have seen nothing that defines that notion clearly enough for it to be describable as a measurement attribute, as opposed to a list of prescriptions.

26. Over the next few weeks, we need to attempt to work up the underlying notion into something that is a candidate for selection as a measurement attribute. That may or may not be achievable, but we should make the effort.

27. There has been a suggestion in the measurement phase of the conceptual framework project that candidate measurement attributes might always be prices rather than values.

This paper uses the term ‘settlement value’ and does not consider whether the underlying notion can be identified as a price of some kind.

Questions for participants

28. **Question 1: Should the Board consider adopting the notion of a settlement value as a measurement attribute for insurance liabilities? If you answer yes, please also answer the following questions:**

    (a) **Is settlement value the right name for the notion you have in mind? If not, what name would you suggest, and why?**

    (b) **How should that notion be defined? How would that definition result in an answer to the questions posed in paragraph 21:**

    (i) What is the basis for deciding which cash flows are included?

    (ii) What is the margin intended to convey?

    (iii) Could gains arise at initial recognition? (We discuss in a separate paper for this meeting whether such gains, if they arise, should be recognised.)

    (iv) Would the credit characteristics of the liability affect its measurement?

29. **Question 2: Paragraph 24 refers to two approaches to setting measurement requirements:**

    (a) **List the building blocks to be used, without trying to come up with a single all-encompassing summary description of what the result means.**

    (b) **Prescribe a consistent measurement attribute that can be described concisely.**
    Paragraph 24 suggests three reasons why the latter approach is preferable: to provide a coherent framework to resolve new and emerging issues, to provide clearer communication with users and to provide measurements that are a faithful representation of some real-world economic attribute of the item being measured.

    Which of those two approaches do you prefer, and why?