



**International  
Accounting Standards  
Board**

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This document is provided as a convenience to observers at Insurance Working Group meetings, to assist them in following the 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 Insurance Working Group Meeting. Paragraph numbers correspond to paragraph numbers used in the Insurance Working group paper. However, because these notes are less detailed, some paragraph numbers are not used.

### **INFORMATION FOR OBSERVERS**

**IASB Meeting:** Insurance Working Group, April 2008  
**Paper:** Non-life insurance contracts (Agenda paper 6)

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#### **Purpose of this paper**

1. This paper considers whether the ‘three building blocks’ approach proposed in the discussion paper is suitable for non-life insurance contracts.
2. The paper discusses:
  - (a) Differences between life and non-life (paragraphs 3-5)
  - (b) Claims liabilities (paragraphs 6-8))
  - (c) Pre-claim liabilities (paragraphs 9-12)
  - (d) Presentation of revenue and expense (paragraphs 13 and 14)
  - (e) Other issues (paragraphs 15 and 16)
  - (f) Questions for participants (paragraphs 17 and 18)

### **Differences between life and non-life**

3. In the discussion paper, the Board expressed the preliminary view that a single model is appropriate for all insurance contracts, life and non-life, direct and reinsurance. The single model uses 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).
4. Some respondents to the discussion paper noted some significant differences between life and non-life contracts. See appendix A to this paper for one of the most detailed descriptions of those differences.
5. Many respondents agreed, explicitly or implicitly, with a single measurement model for all insurance contracts. However, some respondents, particularly some from the US, Bermuda and the Lloyds market, indicated that non-life accounting is not 'broken' to the same extent as life insurance accounting. They suggested that different models might be appropriate for life and non-life contracts. More specifically, they suggested one or more of the following, which are consistent, at least in general terms, with most existing non-life accounting models:
  - (a) Claims liabilities should be measured on an undiscounted basis with no risk margins (paragraphs 6-8)
  - (b) Pre-claims liabilities should be measured using the unearned premium, subject to a liability adequacy test (paragraphs 9-12).
  - (c) Premiums should be recognised as revenue when earned, and claims should be recognised as an expense when incurred (paragraphs 13 and 14).

## **Claims liabilities**

6. Those who opposed discounting and risk margins for claims liabilities offered the following main arguments:
  - (a) Users are familiar with the existing models. Introducing discounting and risk margins would be of limited benefit to them.
  - (b) Including discounting and margins introduces additional complexity, particularly for the most unpredictable type of contracts (eg product liability). (The geographic pattern of the responses to this issue may reflect differences in the nature of contracts written in different countries, as well as other local differences such as the litigation environment.)
  - (c) Because there are few observable benchmarks for the margins, margins will be subjective and lack comparability and transparency.
  - (d) Non-life contracts are primarily priced and managed on the basis of underwriting results.
7. Those who favour including discounting and risk margins in claims liabilities argued as follows:
  - (a) An economically faithful representation cannot ignore the time value of money and the value of risk.
  - (b) Virtually all other measurements of liabilities under IFRSs incorporate the time value of money and the value of risk (although in some cases those effects are partly locked in at inception).
  - (c) If the measurement of insurance liabilities reflects the time value of money and risk, there is less incentive for transactions, such as some financial reinsurance, that exploit uneconomic measurements. In turn, this reduces the pressure on the definition of an insurance contract (and the notion of significant risk transfer) and reduces the possible need for anti-abuse rules.
8. Appendix B to this paper reproduces extracts from the discussion paper that give more detail on arguments for and against risk margins.

## **Pre-claim liabilities**

9. The discussion paper uses the term ‘pre-claims period’ to describe the coverage period when the insurer is standing ready to meet valid claims. The discussion paper noted that, during the pre-claims period of many short-duration contracts, unearned premium may often be a reasonable approximation to the result of applying the three building blocks. However, the discussion paper stated that an insurer should not make this assumption without testing it, particularly if a contract is likely to be highly profitable or highly unprofitable, or circumstances have changed significantly since inception.
  
10. Some respondents suggested that insurers should be permitted or required to measure short-duration non-life insurance pre-claims liabilities using an unearned premium approach. This approach would measure the liability initially at the net premium (the premium received less relevant acquisition costs). Subsequently, the insurer would measure the pre-claims liability at the unearned portion of that net premium. (Some suggested a variant that retains a gross presentation, with the liability measured initially at the premium received and with acquisition costs deferred to be presented as a separate asset). Under this proposal, insurers would not apply the three building blocks, except where needed to carry out a liability adequacy test. Proponents of this approach give the following arguments:
  - (a) For many short-duration contracts, the pre-claims period is short (six months on average for an annual contract). If an insurer identifies significant changes in that short period, the changes are much more likely to lead to losses than to gains. If any material losses exist, a liability adequacy test would detect them. For these contracts, unearned premium may be a reasonable proxy for the result of the three building blocks, but obtainable with less cost and effort.
  - (b) Users are accustomed to using information about earned premiums and incurred claims to derive important ratios, such as claims ratios and combined ratios. A prospective measurement (ie one based on future cash flows) may imply that insurers should report premiums as deposits (not revenue) and claims as returns of deposits (not expenses).
  - (c) Most existing accounting models use an unearned premium approach for non-life pre-claims liabilities.

(d) An unearned premium approach is more consistent with the customer consideration approach that the Board and the FASB are considering as one possible approach in their project on revenue recognition. It is also more consistent with IAS 18. Some saw consistency with IAS 18 as particularly important for non-life contracts because they view them as service contracts rather than financial instruments.

11. Respondents expressed the following concerns about relying on an unearned premium approach, combined with a liability adequacy test:

(a) Insurers might not implement the liability adequacy test rigorously if they rely too much on the adequacy of the unearned premium.

(b) A rule might be needed to describe when an insurer could use the unearned premium approach. This would be a departure from a principles-based approach.

12. Some respondents would incorporate discounting and margins into the measurement of claims liabilities, but for pre-claims liabilities would permit an unearned premium approach (combined with a liability adequacy test).

### **Presentation of revenue and expense**

13. Chapter 7 of the discussion paper discussed the presentation of the performance statement. Because the chapter did not make specific proposals, most respondents provided few, if any, comments on this chapter.

14. Among other things, the discussion paper considered margin approaches and premiums/claim approaches. Some respondents saw a margin approach as appropriate for life insurance contracts but a premiums/claims approach as appropriate for non-life contracts. In this context, some saw life contracts as closer to financial instruments and non-life contracts as closer to service contracts. The presentation of the performance statement will be further discussed in Agenda Paper 8.

### **Other issues**

15. Respondents raised some other concerns about:

(a) the recognition date for insurance contracts, as well as the recognition date for related reinsurance.

(b) the expected value approach for estimating cash flows.

16. The staff has not yet analysed these concerns in detail. However, our initial assessment is that we will resolve most of these concerns with a clearer explanation of the proposal. We will give more thought to these issues, and respondents' concerns, in due course.

### **Questions for participants**

17. **If the Board adopts an approach based on the three building blocks for life insurance contracts, is that approach also appropriate for non-life insurance contracts? Why or why not?**

18. **If you favour different models for different types of contract:**

(a) **where would you draw the line, and why:**

(i) **Life versus non-life?**

(ii) **Protection versus savings?**

(iii) **Short term versus long term?**

(iv) **Short tail versus long tail?**

(v) **More predictable versus less predictable?**

(vi) **Other (please specify)?**

(b) **Should claims liabilities be discounted and include a risk margin? If claims liabilities are undiscounted and include no risk margin, are any specific requirements needed to avoid use of financial reinsurance to manage earnings?**

(c) **For pre-claims liabilities, should an unearned premium approach be required, permitted or prohibited? If an unearned premium approach is required or permitted:**

(i) **should a liability adequacy test be included?**

(ii) **would a liability adequacy test, if any, include margins? If so, how would the margin be determined?**

**(iii) at what level of aggregation should an insurer perform the liability adequacy test?**

**(iv) should an insurer separate any embedded derivatives and measure them at fair value through profit or loss?**

## **Appendix A**

### **Extract from the comment letter from the Group of North American Insurance Enterprises**

#### **Single Measurement Model for Life and Non-life Insurance Contracts**

A fundamental flaw in the DP is that it supports one measurement model for both life and non-life contracts. This is inappropriate in that it ignores the significant, fundamental differences that exist between life and non-life insurance contracts, as summarized below:

- For life contracts, the insured event is generally certain to occur unless the policy lapses whereas for non-life contracts, the insured event may or may not occur.
- For life insurance contracts, the amount of future payment obligation is generally specified, or readily determinable from the contract. For example, whole-life insurance contracts pay an insured upon death (an event certain to occur) and the amount payable at death is specified in the contract. For non-life contracts, the amount of future payment obligation is not specified or readily determinable under the contract (other than in terms of contractual limits). Moreover, in a typical non-life contract, losses, if any, can vary from negligible amounts in excess of deductibles to the contractual limits of the policy.
- For life insurance contracts, the timing of future payments are typically reliably estimable from the contract (e.g., an immediate annuity contract with defined future payments), mortality tables (for annuities with mortality risk), or from a company's own experience (e.g., lapse studies). For non-life contracts, the timing of future payments cannot be reasonably estimated from the contract or by reference to other internal or external data. Stated differently, the uncertainties in a non-life context include not only whether or not a loss may occur during the coverage period (often one year), but also the amount of potential loss, and the fact that losses can be reported several years after the stated coverage period ends and paid years subsequent to the date the loss is reported to the insurer.



Other areas of differentiation include the settlement period between the reporting and payment of claims, which is typically longer for non-life contracts than for life contracts. For example, the period required to determine whether a person has actually died is typically much shorter than the claim settlement period for non-life contracts that often depend on future events. Moreover, while interest is an essential component of pricing and profitability for life products; for non-life contracts, underwriting results are the most critical component of pricing and profitability; and interest, while important, is a secondary consideration.

The following table summarizes these differences:

<b>Key Attributes</b>	<b>Life</b>	<b>Non-life</b>
<b>Period of coverage</b>	Long, extended duration	Short, fixed duration
<b>Probability of insured event occurring</b>	Generally certain; policyholder will either die or lapse	Unknown, none or many claims
<b>Amount of loss if insured event occurs</b>	Fixed and determinable; face value of policy	Unknown, limited by deductible and policy limit
<b>Timing of loss payments</b>	More predictable; supported by mortality, morbidity and lapse studies	Often unpredictable
<b>Loss settlement period</b>	Typically short	Typically long
<b>Data</b>	More empirical data	Less available predictable data
<b>Uncertainty of estimated ultimate claim payments</b>	Low	Generally very high
<b>Interest income impact on product</b>	Essential	Unrelated to underwriting results / incremental

Given these clear and substantial differences between life and non-life insurance contracts, we believe it is appropriate to develop separate accounting models to conform to their unique economic characteristics.

**Appendix B**  
**Arguments for and against discounting non-life claims liabilities**  
**Paragraphs 65 and 66 of the discussion paper**

65 Opponents of discounting non-life claims liabilities make the following arguments:

- a. Discounting of life insurance liabilities is uncontroversial because life insurance cash flows are relatively predictable. However, that is not the case for many types of non-life insurance. Scheduling estimated payments and determining a discount rate introduces additional subjectivity. This would reduce comparability and permit earnings management. Moreover, scheduling involves additional cost that outweighs possible benefits for users.
- b. Some users express concerns that some non-life insurers tend to underestimate their insurance liabilities. Discounting might exacerbate those understatements, depending on how the technique is applied and on the assumptions used.
- c. Discounting accelerates recognition of future investment income. This is imprudent and encourages imprudent underwriting practices, such as ‘cash flow underwriting’ (when pricing assumes that future investment income will offset underwriting losses).
- d. Some non-life insurance liabilities generate cash flows that vary with price changes. They are sometimes ‘implicitly’ discounted by being measured at undiscounted amounts that ignore future inflation. Particularly for short-tail liabilities, this may give a reasonable approximation with less cost and complexity than explicit discounting.
- e. If claims liabilities are undiscounted and do not include risk margins, that is an implicit assumption that discounting and risk margins tend, in practice, to offset each other.
- f. Users rely on disclosure of prior year loss development to understand and test the risks and uncertainties inherent in estimates of cash flows and the effect of changes in those estimates. This may become more difficult if the

measurement introduces more variables (for the time value of money and for risk margins).

- g. Using a current discount rate will increase the volatility of the amounts reported in the balance sheet and income statement. This may make it more difficult for users to understand an insurer's performance.
- h. It is confusing to report interest expense on a liability that does not bear interest
- i. It would be preferable to confine discounted measurements to supplementary disclosures until users and preparers become more familiar with them. Some analysts prefer to eliminate the effect of discounting from claims liabilities. This may be partly so that they can make comparisons with insurers in those countries where most claims liabilities are undiscounted and partly because they believe that the undiscounted amounts may be underestimated and prefer those amounts not to be reduced by discounting.

66 However, for the following reasons, the Board's preliminary view is that discounting should be used for all insurance liabilities:

- a. Although discounting may cause some increase in both subjectivity and cost, the increase in relevance outweighs these concerns, for the following reasons:
  - i. Insurers and investors are not indifferent to the timing of cash flows. An amount payable tomorrow is not equivalent to the same amount payable in ten years. If a balance sheet measures those obligations at the same amount, it does not represent faithfully the insurer's financial position and is less relevant to users.
  - ii. Undiscounted measurements create opportunities for transactions (for example, some financial reinsurance transactions) that exploit divergences between the accounting representation of the liabilities and their economic substance.

- iii. IFRSs already require discounting for all other comparable items, such as long-term provisions, employee benefit obligations and finance leases. Extending discounting to all insurance liabilities will make financial statements more internally consistent, and hence more relevant and reliable.
  - iv. Discount rates and the amount and timing of future cash flows can generally be estimated in practice in a sufficiently reliable and objective way at a reasonable cost. Absolute precision is unattainable, but it is also unnecessary. Discounting can be applied in a way that leads to answers within a reasonably narrow range and results in more relevant information for users. Indeed, many entities already have experience of discounting, both to support investment decisions and to measure items for which IFRSs already require discounting.
  - v. In some cases, discounted measurements may be more reliable, and less subjective, than undiscounted measurements. When measurements include the effect of inflation explicitly or implicitly, insurers already need to schedule payments. The effect of the time value of Money tends to offset much of the effect of inflation, and variations in estimates of cash flows far in the future are smaller when reduced to their present values.
- b. If it is true that some insurers underestimate claims liabilities, the appropriate response is to improve the methods used to make those estimates, not to compensate for those underestimates by excluding an economically relevant factor from the measurement. If, as some assert, some insurers are unwilling or unable to make measurements that represent faithfully what those measurements purport to represent, that is no reason to adopt a less relevant measurement objective.
  - c. Discounting does not accelerate the recognition of investment income. Rather, it represents faithfully the economic fact that money has a time value.

- d. Implicit discounting makes the unrealistic assumption that two different variables (claim inflation and time value) will more or less offset each other in every case. Requiring explicit estimates of these effects will improve financial reporting. Moreover, experience has shown that making explicit estimates improves entities' ability to make unbiased estimates of cash flows.
- e. Measurements that consider the time value of money and risk margins separately and explicitly will be more relevant to users and more reliable than measurements that assume, with no testing, that these two factors cancel each other out in all cases.
- f. Inclusion of discounted measurements in the balance sheet does not preclude disclosures about undiscounted loss development if that disclosure is helpful to users.
- g. Discounting is consistent with rational pricing decisions, which typically reflect the time value of money and the risk inherent in the contract. Therefore, any volatility resulting from discounting is a faithful representation of an insurer's activity.
- h. Although claim liabilities do not bear explicit interest, interest is implicit in the pricing of insurance contracts.
- i. Appropriate recognition and measurement provide a structured aggregation of financial information. Disclosure can provide valuable supporting information, but is not an adequate substitute.
- j. Some countries have introduced discounting and risk margins and would consider it a backward step to remove them.