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International
Accounting Standards
Board

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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: October 2008, London

Project: Insurance Contracts

Subject: Education session: Overview of comments on the measurement attribute (Agenda Paper 3A)

Purpose of this paper

1. This paper summarises the constituent's reactions to the discussion paper (DP) *Preliminary Views on Insurance Contracts*, regarding a measurement attribute.
2. This paper firstly deals with the:
 - (a) **measurement attributes** suggested by respondents
 - (b) the **features or building blocks** that respondents argued would be needed for a relevant, reliable and implementable measurement approach
 - (c) possible **performance reporting** models.

Measurement attribute

3. The discussion paper proposed the measurement attribute current exit value. In order to measure a current exit value, in practice, a building block approach has to be used - as a current exit value would rarely, if ever, be observable.

4. In general terms, respondents supported the three building blocks proposed in the discussion paper, though virtually all had significant reservations about some aspects of the proposals. Nevertheless, the opinions on current exit value were diverse.
 - (a) Many respondents do not regard current exit value as a meaningful measurement approach if an entity can actually neither measure the liability based on an observable market price nor transfer the liability. Respondents' arguments against the current exit value notion were also presented previously in September agenda paper 14A and are repeated in the appendix to this paper.
 - (b) Some other respondents had no concerns about current exit value, mostly on the grounds of consistency with IAS 39 *Financial Instruments: Recognition and Measurement*.
 - (c) Some respondents stated explicitly, and others implied, that it would be sufficient to use appropriate building blocks and that it would be unnecessary to identify an explicit measurement attribute corresponding to those building blocks.
5. While opposing current exit value, many respondents tried to find a measurement attribute that they found more persuasive. This is an overview of the suggestions made:
 - (a) **Settlement value** or some kind of current or present value as well as value on intended exit (or fulfilment value). Most respondents suggested a notion that refers to the fact that an insurer generally expects to settle its liabilities over time by paying benefits to policyholders as the benefits fall due. In essence, they argue this would reflect how insurance contracts are managed and priced in practice. Further, they commented that this could not only lead to a more robust measurement but also would convey an insight in the management's assessment, which some users of financial statements regard as decision-useful information.
 - (b) **Unearned premium** model: as the insurer is released from risk, the related part of the premium is regarded as earned and recognised as revenue. The unearned part of the premium is recognised as a liability. A liability adequacy test (onerous contract test) would be carried out to test whether the liability is inadequate. Proponents of the unearned premium model would use it for the pre-claims period of short-duration contracts, particularly in non life insurance.

- (c) **Expected cash flows, undiscounted and with no risk margins.** Some respondents would use this approach for the post-claims period of some or all non-life insurance contracts.
- (d) **Current pricing** or entry value: broadly comparable to a current exit approach, but emphasizes that an insurer would make its estimates on the basis of its own actual pricing methodology. Therefore, this label would force the insurer to remeasure its contracts according to its current pricing. An entry value precludes the recognition of day one differences. This measurement attribute had very little support amongst the respondents. (Some respondents used the term ‘current entry value’ to describe what the discussion paper called implementation A of current exit value, ie a current exit value, but calibrated to the premium.)
- (e) **Embedded value** approaches that measure insurance liabilities by discounting all cash flows that belong to the liabilities and related assets, and then deducting the measurement of the assets to arrive at a measurement of the book of contracts. Very few respondents advocated embedded value approaches.

Features of a measurement attribute and building blocks

6. Respondents had many concerns relating to current exit value. These concerns were either additional to or independent of their concerns regarding the measurement attribute. The respondents’ concerns can be structured as:

- (a) Although the vast majority of respondents supported the use of **observable market prices** for items such as interest rates and traded equity prices, most respondents disagreed with using a hypothetical market as a benchmark for inputs that are not observable in the market. They argued that insurers should use their own inputs without adjusting them to reflect the estimates that a market participant would make. Several respondents argued that the entity’s own assumptions would generally not significantly differ from market participant’s estimates.
- (b) The vast majority of the comment letters generally supported reflecting the **time value of money**. However, some respondents disagreed for non-life claims liabilities. Most respondents agreed that the discount rate for should reflect the characteristics of the liability rather than those of the assets backing those liabilities. However, a few

respondents advocated asset-based rates, suggesting that this is consistent with how insurers price contracts and noting that if asset-based rates are not used, large losses could arise at the inception of some contracts that the insurer expects to be profitable.

- (c) Most respondents supported the idea of including a **risk margin** in general. However, for non-life insurance claims liabilities, those who opposed the inclusion of the time value of money also opposed the inclusion of a risk margin. Many respondents argued that the Board should narrow the range of acceptable models to calculate a risk margin; whereas others agreed with providing principles and leaving more detailed requirements to bodies such as the International Actuarial Association (IAA). Many respondents were concerned that it would not be possible to find sufficient and appropriate market inputs and observable benchmarks. Some respondents opposed a market-based risk margin, but did not necessarily suggest an alternative. Some argued that the risk margin should reflect the cost of bearing risk, but not include any further profit that the entity or a market participant would require for bearing the risk. The majority of respondents agreed that the risk margin should measure the remaining risk and not be used as a “shock absorber” to absorb adverse developments.
- (d) Most respondents did not understand the idea of a **service margin** and perceived it as a plug to maintain some consistency with IAS 18 *Revenue*. Other respondents could not see any benefit in splitting a hypothetical service margin from the risk margin. Some respondents seemed to find it easier to think of the price that would be paid to outsource any separate services provided under the contract; the outsourcing price would include a service margin.
- (e) Respondents were divided on whether it would be acceptable or desirable to recognise a net¹ **profit at inception**. Some respondents, contrary to the preliminary views expressed in the discussion paper, believed that net profits at inception would be common and significant if the initial margin is not calibrated to the premium.
- (f) Most respondents believed that **credit characteristics** should not be part of a measurement attribute for insurance contracts because they felt that measuring those characteristics would not have much relevance for users.

¹ In this context net profits mean gross profits less acquisition costs.

7. Respondents stated their objections to some other issues mentioned in the discussion paper. These issues are excluded from this paper, because staff did not find them particularly relevant for the discussion of the measurement attribute. We will deal with these other issues separately.

Performance reporting

8. Respondents did not broadly comment on performance reporting issues, which is mainly a consequence of the fact that the discussion paper did not include specific proposals on these issues.
9. Most respondents felt uncomfortable commenting on performance reporting at a stage when the measurement attribute is not specified yet. Staff also considers performance reporting as being strongly related to the chosen measurement attribute. Basically, two performance reporting approaches can be distinguished.
10. The premiums and claims approach recognises premiums as revenue, whereas the margin presentation considers premiums as deposit receipts and changes in the insurance liability as deposit repayments.
11. The vast majority of respondents considered all premiums as revenue. Some distinguished between life and non-life insurance on this question, regarding life insurance premiums as deposits and non-life insurance premiums as revenue. Some supported the use of a margin presentation, particularly for life insurance contracts. Others suggested retaining the revenue presentation in the performance statement while providing a margin analysis in the notes, for eg life insurance contracts.
12. The discussion paper discussed in very general terms how changes in insurance liabilities could be disaggregated in the performance statement, but did not propose any particular approach. The respondents did not comment on this in detail, but asked the Board to develop principles and retain the strong points of existing practice. Some respondents suggested to disaggregate according to the building blocks or to reflect differences in the quality of inputs, eg to distinguish the effects of observable inputs from the effects of unobservable inputs.

13. The vast majority of the respondents agreed that changes in insurance liabilities should be reported in profit or loss, whilst others encouraged the use of other comprehensive income (OCI) for changes in insurance liabilities to avoid accounting mismatches with financial assets backing the liability and categorised as available-for-sale (AFS) and to deal with concerns about volatility.

Appendix: Board Meeting September 2008 - Agenda Paper 14A

Extract

6. In very general terms, respondents largely support the three building blocks proposed in the discussion paper, but there is significant opposition to current exit value (and significant support for some sort of fulfilment value), mainly for the following reasons:
- (a) Respondents do not view current exit value as relevant if an entity cannot actually transfer the liability. Many respondents view this as referring to a hypothetical transaction that does not reflect the way the business is managed - users would find such a notion difficult to understand.
 - (b) Estimates under current exit value should be consistent with those of a market participant. Current exit value also excludes entity-specific cash flows. However, most respondents believe that the most relevant measure of the liability uses the estimates and cash flows of the insurer, not those of a market participant for the following reasons:
 - (i) It would be unreasonable to require insurers to go to exceptional lengths to demonstrate that their own inputs are in line with the market. Moreover, it may be difficult to persuade auditors and regulators that the insurer has done enough work to confirm that its inputs are in line with those incurred by other market participants.
 - (ii) Insurers price contracts by reference to their own inputs. Thus, a measurement based on market-participant inputs could lead to a gain or loss at inception, which would reverse in later periods as the insurer provides the services.

(iii) It is often not possible to observe directly what cash flows market participants would incur. Moreover, any apparent differences between those cash flows and entity-specific cash flows 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' cash flows may be less robust than the entity's estimates of its own cash flows.

(iv) Differences between market participants' expenses and entity-specific expenses could also relate to different levels of service provided and the approach to claims management. Adjusting the entity's own expenses could therefore lead to inconsistency (asymmetry) with other estimates like mortality and lapses.

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

(d) Whether gains should be recognised at inception of an insurance contract. Views are mixed on this.

[...]

11. Respondents had some other concerns about current exit value (and its building blocks).

We do not intend to discuss these concerns in this paper as they do not seem to be relevant to the question of whether fulfilment value is more appropriate than exit value. We will address these issues in more detail at a later stage of the project as a part of a broader discussion on the measurement attribute.

(a) Discounting for non-life claims liabilities [some respondents favour a separate model for non-life contracts, irrespective of whether the Board ends up choosing fulfilment value or exit value].

(b) Policyholder behaviour and policyholder participation.

(c) Acquisition costs.

(d) The impact of diversification on risk margins.

- (e) The meaning of service margins.
- (f) The structure of the performance statement.