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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: Candidate measurement approaches (Agenda Paper 3B)**

Purpose of this paper

1. This paper presents a list of those measurement approaches that the staff views as viable candidates for selection in the case of insurance liabilities. This paper will also discuss the main features of the candidates and some considerations on selecting between the candidates.
2. At this stage, staff does not intend to discuss which candidate is preferable, to make a choice between the candidates or to seek any other Board decisions; this will be part of future Board meetings.
3. The rest of this paper deals with the following subjects:
 - (a) What are the candidates (paragraphs 9-13)?
 - (b) The similarities and differences between candidates 1 to 4 (paragraphs 14-21)
 - (c) Overview of key considerations for deciding between the candidates 1 to 4 (paragraphs 22-33)

- (d) What measurement approaches are not in the list of candidates (paragraphs 34-40)?
 - (e) The unearned premium approach for pre-claims liabilities (candidate 5) (paragraphs 41-46)
 - (f) The next steps (paragraphs 47-48)
4. This paper discusses the objective of the margin(s) included in each of the candidates. Staff does not intend to provide a detailed discussion on how margins should be estimated.
 5. Staff has identified some issues as not specifically relating to choosing a measurement approach. We therefore do not intend to discuss these features in this paper and will address these issues in more detail at a later stage:
 - (a) Policyholder behaviour and policyholder participation.
 - (b) The impact of diversification on risk margins.
 - (c) The attributes of the discount rate in relation to the characteristics of the cash flows of the insurance liability (for example for timing, currency and liquidity).
 - (d) Whether other comprehensive income (OCI) could be used for recognising some changes in insurance liabilities.
 6. We do not intend to prejudge whether all the candidates are attributes. We therefore choose to refer to the candidates as ‘measurement approach’ throughout this paper. In paragraphs 30-32 and 44 we consider whether the candidates are attributes of insurance liabilities.
 7. Agenda paper 3A gives an overview from the comment letters of the responses on the measurement approach. Agenda paper 3C provides a tabular comparison between the main features of the candidates.
 8. Agenda paper 3D provides an example showing how each candidate works, focussing on risk margins, day one differences and subsequent changes in estimates. It also demonstrates the interaction between margins in the balance sheet and subsequent release of margins in the performance statement.

What are the candidates

9. This paper identifies five viable candidates for being selected as measurement approaches for insurance contracts.
 - (a) 1- Current exit value as proposed by the discussion paper (DP) *Preliminary Views on Insurance Contracts*.
 - (b) 2- Current fulfilment value including a risk margin based on the cost of bearing risk.
 - (c) 3- Current fulfilment value including a risk margin based on the cost of bearing risk and, separate from the risk margin, an additional margin as the difference between the premium and the expected value of the cash flows plus the margin for bearing risk.
 - (d) 4- Current fulfilment value including a single margin calibrated at inception to the premium.
 - (e) 5- Unearned premium for the pre-claims liability of short-duration contracts.
10. Paragraph 9 lists the candidates in no particular order; the sequencing does not relate to any kind of preferences.
11. Candidates 1 through 4 all use a building block approach for measuring the insurance liability and can be applied to all types of insurance contracts. In the DP the Board expressed the preliminary view that candidate 1 is the selected measurement approach for insurance contracts. Candidate 2 and 4 correspond with the two approaches to fulfilment value described during the September Board meeting¹; candidate 2 corresponds with approach A and candidate 4 corresponds with approach B. Candidate 3 combines some characteristics of both candidate 2 and 4; this will be further explained in paragraph 30.
12. The DP discussed candidate 5 as a measurement approach for the pre-claims period of short-duration contracts (using a building block approach for all other contracts). Alternatively, the DP looked at the possibility to use an unearned premium approach to short-duration contracts as a proxy for an approach based on building blocks.

¹ September 2008, Agenda paper 14A

13. We first describe the similarities between candidates 1 through 4. Later in the paper, we discuss the unearned premium approach (candidate 5).

The similarities and differences between candidates 1 to 4

14. The DP proposed that insurers should measure insurance liabilities at current exit value. Because current exit value would rarely, if ever, be observable, it would be estimated using a building block approach:

- (a) Current estimates of cash flows
- (b) Time value of money
- (c) A margin

15. Candidates 1 through 4 all use this building block approach as a basis for measuring the liability. The tabular comparison in agenda paper 3C provides an overview of the similarities and differences between the candidates. In some respects, the candidates are quite similar:

- (a) consistency with observable market prices for factors such as interest rates and equity prices.
- (b) using current estimates of cash flows, rather than locked in estimates.
- (c) recognising changes in estimates in the income statement. [Some respondents suggested variations that would recognise some changes in other comprehensive income. We intend to discuss this issue at a future meeting.]
- (d) reflecting the time value of money.
- (e) including a risk margin, and recognising income in line with the release from risk.
- (f) recognising some income on day one associated with the recovery of acquisition costs.

16. The candidates differ in the following respects:

- (a) Differences relating to the principle for the measurement approach (transfer versus fulfilment), including:

- (i) Estimates for which no observable market information is available
 - (ii) Cash flows that arise from the characteristics of the entity
 - (iii) Own credit risk
- (b) Difference relating to margins and day one profits, including:
- (i) Risk margins
 - (ii) Service margins
 - (iii) Day one difference² [During the September meeting, staff explained that it prefers to use the term ‘day one difference’ in order not to prejudge a discussion on day one profits in one direction or the other.]

17. Current exit value (candidate 1) looks to a transfer to a third party at the reporting date. The objective of the measurement is therefore to capture the characteristics of the liability in a way that reflects the view of market participants. Some of the main features of this candidate are:

- (a) estimates should be consistent with those of market participants [In practice, for estimates that cannot be based on observable market information, the estimates of the insurer’s own cash flows are the natural starting point, but the insurer would need to adjust these if it concludes that market participants would make different estimates].
- (b) any cash flows specific to the entity have to be excluded.
- (c) the margin reflects the margin required by market participants. This margin required by market participants includes a risk margin, but also includes a margin for other services if market participants require such a margin.

² In the example in agenda paper 3D, staff distinguishes a ‘gross day difference’ and a ‘net day one difference’. The gross day one difference is the difference between the premiums less the expected value of the cash flows. The net day one difference is the difference between the premium less the relevant acquisition costs and the expected value of the cash flows plus the margin. When using the term ‘day one difference’, staff is usually referring to a net day one difference.

(d) candidate 1 may use the premium for a reasonableness check, but the premium does not override an unbiased estimate of the margin required by market participants. Therefore, candidate 1 can result in a day one difference.

(e) own credit risk is included, for both initial and subsequent measurement.

18. The three other candidates are based on current fulfilment value (candidates 2 through 4).

The measurement objective is to capture the burden for the insurer of working out the obligations with the policyholder over time. Some of the main features are:

(a) when no observable market information is available, inputs should be based on the insurer's own estimates.

(b) cash flows should be based on the entity's own cash flows and, consequently, could include some cash flows that would not occur for other market participants.

(c) own credit risk is excluded (except to the extent that it is implicit at inception in a calibration to the premium).

19. However, the candidates based on fulfilment differ in how they establish the margin and treat day one differences.

(a) Candidates 2 and 3 do not use the premium for estimating the risk margin; the risk margin reflects the entity's cost of bearing risk. Therefore, candidates 2 and 3 can lead to a day one difference.

(i) Candidate 2 would recognise the day one difference in profit or loss.

(ii) Candidate 3 would recognise the day one difference as a part of the insurance liability, separate from the risk margin. We tentatively refer to this separate margin as the 'additional margin'. This additional margin could arise from various items, such as service margins (of the kind included in current exit value), selling margins, recovery of past investment and measurement errors. Often, perhaps all of these factors are present and proponents of candidate 3 might argue that it is impracticable to quantify them separately from each other. The additional margin would be locked-in at inception as it does not seem useful to subsequently remeasure a component of the liability that is a mixture of things. The additional

margin will be released to the income statement over time. However, since the additional margin is a blend, it may be difficult to determine an appropriate driver for the release of this margin; if no other driver is available, perhaps release from risk could be used as a default.

(b) Candidate 4 uses the premium as the basis for determining the initial risk margin, so no day one difference can occur. However, this margin would arguably include not only a margin for risk, but also other margin components (for reasons of convenience, we refer to the margin of candidate 4 as a risk margin throughout this paper)³. In contrast to candidate 3, candidate 4 builds on the presumption that the actual premium is the best (and perhaps only) evidence of a real market transaction. Proponents of candidate 4 do not consider a split between a risk margin and an additional margin reliable and useful. As a consequence of calibrating to the premium, a liability adequacy test is required at inception since the premium may not be sufficient to cover the obligations. This paper does not discuss the basis of comparison for that liability adequacy test: natural choices might be current exit value, current fulfilment value (the candidate 2 version) or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Subsequently, the risk margin is locked-in, but no liability adequacy test is needed since this approach is based on the rationale that no subsequent information will provide better evidence of the margin per unit and because all other building blocks of the measurement use current information.

20. The additional margin from candidate 3 would not be the same as the service margin from candidate 1. In contrast to the additional margin, a service margin would include only the margin for other services (if any) required by market participants, not other components (if any) of the additional margin. Moreover, the service margin (candidate 1) is continuously remeasured, whereas the additional margin (candidate 3) is locked in at inception and subsequently released in line with the release from risk or other driver, as discussed in paragraph 19(a)(ii).

21. Some have suggested recognising the day one difference as a liability, separate from the insurance liabilities. However, recognising the day one difference as separate item within

³ Some refer to a margin that is a result of calibrating to the premium as a ‘composite margin’.

other liabilities would result in more than one obligation within the balance sheet for the same contract. We believe that, unless an insurance contract is split into two or more separate components, the additional margin should be part of the insurance obligation.

Overview of key considerations for deciding between the candidates 1 to 4

22. In the previous section we briefly discussed the main features of the four candidates based on building blocks. Staff believes that, broadly, key considerations for deciding between these candidates are:

- (a) What should the measurement objective be: transfer or fulfilment?
- (b) Use the premium as a basis for the required margin or not?
- (c) Are the candidates measurement attributes?

What should be the measurement objective: transfer or fulfilment?

23. Those who prefer a measurement approach based on a transfer notion believe that such a notion gives the most relevant and reliable information on insurance liabilities. Candidate 1 is based on a transfer notion (label: current exit value). When choosing a transfer as the measurement objective, it is inevitable that estimates will have to be consistent with estimates that a market participant would make. For estimates that cannot be based on observable market information, the entity's own estimates can be a likely starting point, although a transfer-based notion can result in the insurer adjusting its own estimates in order to make those consistent with the estimates of a market participant. Choosing transfer also implies that own credit risk is one of the characteristics of the insurance liability, for both initial and subsequent measurement.

24. Others believe the measurement objective should be to capture the burden of fulfilling the contract with the policy holder over time; they argue that this would provide an appropriate reflection of the way the business is managed. When no observable market information is available, proponents of this view consider estimates and cash flows of the insurer to be the most relevant measure of the liability; not those of a market participant. Candidates 2 through 4 are based on a fulfilment notion (label: current fulfilment value). In relation to own credit risk, it could be argued that the possibility of default reduces the burden of the insurer's obligation. Nevertheless, because all proponents of a fulfilment

notion opposed the inclusion of own credit risk, candidates 2 through 4 exclude own credit risk.

25. Further implications of the choice between transfer versus fulfilment are:

- (a) A notion based on transfer provides a measurement objective that gives a frame of reference for all estimates and tells the insurer which cash flows to include.
- (b) However, estimating the estimates that market participant would make may come with considerable challenges, particularly for those estimates for which no observable market information is available.
- (c) A notion based on fulfilment is consistent with how insurers generally extinguish their insurance liabilities: working out the obligations with the policyholders over time.
- (d) Choosing fulfilment as the measurement objective would include in the measurement of the insurance liability some entity-specific characteristics, although we believe that these circumstances probably will not be common and will be limited to the expenses⁴.
- (e) Fulfilment value does not automatically provide a principle for the margin; different views on this are possible, as evidenced by the fact that we present three candidates based on this notion.

Use the premium as a basis for the required margin or not?

26. One view on margins is that the observed price for the transaction with the policyholder does not provide the most appropriate calibration point for the margin. The insurance markets with the policyholders are not sufficiently deep and liquid, using premium pricing for estimating the risk margin would reduce comparability. Furthermore, insurers continue to use different approaches to pricing and may also reflect entity-specific objectives in pricing. Therefore, the premium should not override an estimate of the margin, although it could provide a useful reasonableness check on the initial measurement. This view can result in a day one difference.

⁴ In this context, ‘expenses’ refers to the costs of administering insurance contracts during their lives, rather than cost of the underlying claims.

- (a) For those who prefer a transfer notion, the estimate of the margin would be based on the margin another party would require (candidate 1). The day one difference, if any, would be recognised in the income statement.
- (b) Those who favour a fulfilment notion would estimate the margin as required by the insurer, eg the margin required for the cost of bearing risk. Candidate 2 would, similar to candidate 1, recognise the day one difference in the income statement. Candidate 3 would recognise the day one difference as an additional margin within the insurance liabilities at inception and will subsequently recognise the release of that additional margin in the income statement over time.

27. Another view is that the actual premium is the best (and only) evidence of a real market transaction. The point of sale is the only point at which a real life calibration of margins is possible and it is not possible to split any other margin reliably from risk margins at this stage. This approach therefore calibrates the initial margin directly to the premium and does not allow for day one profits. This approach does not allow for a day one difference. Candidate 4 is based on this view.

28. Further implications for risk margins are:

- (a) For candidates 1 through 3, the definitions of current exit value and current fulfilment value provide a principle for what the risk margin should represent. [Although the definition of fulfilment value does not provide a principle for measurement of the additional margin of candidate 3]. To estimate this margin, the insurer generally depends on models. The various models may end up in similar answers, but that does not necessarily have to be the case.
- (b) Candidate 4 calibrates the risk margin to the premium. By applying this principle, the insurer does not depend on models for estimating the risk margin at inception (though a model is still needed to determine how the margin is released over time). However, the principle for estimating the risk margin does not seem to flow from the definition of fulfilment value.

29. Further implications for day one differences are:

- (a) Candidate 1 and 2 do not calibrate to the premium, although the premium may provide a reasonableness check. The DP took the position that day one profits (or differences) would not be common and significant. However, a fair number of respondents believe that, under current exit value or other measurement approaches that do not calibrate the initial margin to the premium, day one differences would be common and significant.
- (b) Candidate 3 and 4 both do not recognise the day one difference in the income statement, although the candidates differ in how they avoid a day one gain. By having no day one gain, these candidates would be more consistent with the customer consideration approach from the Revenue recognition project. Both candidates would also be more consistent with IAS 18 *Revenue* and IAS 39 *Financial Instruments: Recognition and Measurement*. IAS 39 prohibits the recognition of gains at inception if they are not evidenced by comparison with other observable current market transactions or not based on a valuation technique whose variables include only data from observable markets.⁵ Measurements of insurance contracts would always rely largely on data that are not observable.
- (c) Candidate 4 needs a liability adequacy test (onerous contract test) at inception. From the way candidate 4 estimates the margin (calibrate to the premium), it is not immediately clear whether this onerous contract test includes a margin and, if so, what the margin for the onerous contract test should be.

Are the candidates measurement attributes?

30. The objective of Phase C, Measurement, of the Conceptual Framework project is to select a set of measurement bases (or attributes) that satisfy the objectives and qualitative characteristics of financial reporting. The Conceptual Framework project could conclude that measurements should always aim to be a faithful representation of some real-world economic attribute of the item being measured. One of the key considerations could therefore be whether the candidates are attributes of an insurance liability. However, the measurement phase of the Conceptual Framework has yet to conclude its work on measurement attributes. Furthermore, the description of the candidate measurement

⁵ IAS 39 Appendix A, paragraphs AG71 and AG76 and *Basis for Conclusions on IAS 39*, paragraph BC98.

approaches for the Insurance project is still tentative. We therefore discuss whether, in staff's view, the candidates can ultimately become a measurement attribute.

31. Candidate 1 provides a concise and rigorous definition of a measurement objective that contains a clear point of reference (a transfer to a market participant). Staff therefore believes that candidate is likely to be an attribute of insurance liabilities.
32. Staff also believes that candidate 2 can be viewed as an attribute of the insurance liability; the risk margin flows quite naturally from the definition of fulfilment value.
33. As a consequence of how fulfilment value is tentatively defined, staff is not convinced that, candidates 3 and 4 could be viewed as an attribute of the insurance liability. The risk margin does not follow from the definition of the measurement approach. Thus, candidates 3 and 4 seem to be a hybrid of two measurement approaches.

What measurement approaches are not in the list of candidates?

34. We considered various other measurement approaches but did not include them in the list of candidates, for the following reasons:
 - (a) Current entry value and embedded value (paragraph 35)
 - (b) Customer consideration approach (paragraph 36)
 - (c) The measurement approach in IAS 37, as updated in the Liabilities project (paragraph 37)
 - (d) The approach in IAS 39 (paragraphs 38-39)
 - (e) expected cash flows, undiscounted and with no risk margins (paragraphs 44-45)
35. Some measurement approaches that were visited in the DP got little support in the comment letters (current entry value, embedded value). These measurement approaches were already considered in the DP; the Board expressed the preliminary view that current exit value was a more relevant measurement approach. Staff therefore believes that these approaches should not be considered any further as candidates for selection.
36. The DP discussed a measurement approach based purely on allocation of the customer consideration, as discussed in the project on revenue recognition. The DP took the

position that the customer consideration model was unlikely to be suitable for insurance liabilities unless it is developed in a way that involves explicit current estimates of the cash flows, the time value of money and explicit margins. The staff believes that position is still appropriate. Furthermore, two other consequences of a customer consideration model would be problematic for insurance contracts:

- (a) Allocation of the premium: the customer consideration approach requires recognising the consideration (premium) as the performance obligations are satisfied. This may result in an awkward presentation for some types of insurance contracts. For example, for single premium immediate annuities, the customer consideration model would require the insurer to recognise the premium received as a performance obligation and then release part of the premium to revenue in each period.
- (b) Day one differences: the customer consideration approach does not allow any income to be recognised on day one. As a result, no (gross) income can be recognised at inception to cover acquisition costs and no (net) day one differences can occur. Some of the candidates (candidates 3 through 5) would also end up with no (net) day one differences in the income statement, but all the candidates would recognise some (gross) income on day one related to acquisition costs⁶.

37. Another possibility we considered was simply to adopt the measurement approach in IAS 37, as updated by the ultimate outcome of the project to amend IAS 37 (Liabilities project). That approach refers to the amount to transfer the liability (similar to current exit value) or to settle it with the counterparty at the reporting date. In practice, that measurement would be estimated by using building blocks similar to those discussed in the DP on insurance contracts (though perhaps not identical in all respects). The Board has yet to conclude on the measurement approach in the Liabilities project, including the role of margins; the candidates in this paper therefore do not include the measurement approach in the liabilities project.

⁶ The DP took the position that acquisition costs should be recognised as an expense. At the same time, the insurer would recognise income; that income reports the recovery of those costs from cash already received or from the present value of future receipts qualifying for inclusion in the measurement of the liability. The income related to acquisition costs recognised on day one should be treated as the recognised part of the customer relationship, reducing the related insurance liability.

38. We considered whether to adopt the measurement approach(es) in IAS 39. If the Board did this, it would need to consider whether to require measurement at fair value or amortised cost, a choice between these measurements or fair value in specified cases and amortised cost in other specified cases.

(a) An amortised cost measurement would involve a current estimate of expected cash flows and a locked-in discount rate, covering both the time value of money and the risk margin. We did not include amortised cost in the list of candidates, because applying this model to insurance liabilities would not produce useful information and would involve many complexities and arbitrary features, such as:

(i) separating embedded derivatives

(ii) dealing with the inherent variability of cash flows from insurance liabilities, which is likely to be much greater than for many of the financial assets and financial liabilities for which the amortised cost model is used.

(iii) dealing with interactions between changes in market interest rates and changes in the liability cash flows, for example interest-sensitive lapse rates.

(iv) distinguishing new contracts (with a new discount rate) from amendments to an existing contract (which would continue to use the same discount rate).

(b) A fair value approach would be similar – and perhaps identical – to current exit value, as described in the DP. Accordingly, we do not present it as a separate candidate.

39. Many insurers issue some contracts that are within the scope of IAS 39, for example some long-term savings contracts that do not transfer significant insurance contracts. Similarly, many insurers – particularly life insurers – provide services outside insurance contracts. For example, many provide investment management services to mutual funds or collect investment management fees for investment contracts. Those services are within the scope of IAS 18, which applies an approach similar to the customer consideration approach. In considering what approach to adopt for insurance contracts, the Board may need to consider the implications of applying:

- (a) the IAS 18 approach to services sold separately and a different approach to services sold as part of an insurance contract.
- (b) The IAS 39 approach to financial instruments sold separately and a different approach to financial instrument components of an insurance contract.

40. The discussion paper considered whether insurance contracts should be unbundled if the contract contains different components that would be subject to different accounting requirements if sold separately. Although unbundling might mitigate accounting discontinuities in such cases, many respondents to the DP highlighted both practical and conceptual problems that could arise from unbundling. We will consider at a later date whether unbundling should be required.

The unearned premium approach for pre-claims liabilities (candidate 5)

The features of an unearned premium approach

41. The unearned premium approach (candidate 5) would apply, if adopted, only for the pre-claims⁷ period of short-duration contracts. All other insurance liabilities (including short-duration claims liabilities) would be measured using whichever of candidates 1 through 4 is selected by the Board; an unearned premium is unlikely to be suitable for those contracts since they can cover many reporting periods and the associated cash flows can be highly uncertain. The unearned premium is based on allocation of the customer consideration (the premium) and would be remeasured only if onerous. It therefore differs from the other proposals on many features, eg:

- (a) no time value of money.
- (b) no explicit risk margins.
- (c) no subsequent measurement unless onerous.
- (d) calibration to the premium (no day one differences).

⁷ The pre-claims period refers to the coverage period when the insurer is standing ready to meet valid claims. The claims period is used when the insured events have occurred but the ultimate payment is still uncertain.

42. The DP identified this approach as a possible proxy for the current exit value for pre-claims liabilities of short duration contracts. However, some respondents see this approach as conceptually the best answer for these types of contracts. Candidate 5 can therefore be used in two ways.

- (a) As the selected measurement approach for the pre-claims period of a number of short-term duration contracts. This would allow insurers to adopt a simpler measurement approach in cases when a more sophisticated approach might not be justified on cost-benefit grounds.
- (b) As a reasonable approximation to the pre-claims liability of one of the candidates 1 through 4, typically applied to short-term duration contracts. This would maintain a consistent approach for all insurance liabilities and avoid the need to define which liabilities qualify for a different approach.

43. Further considerations on an unearned premium are:

- (a) The unearned premium approach would be more consistent with the customer consideration approach from the Revenue recognition.
- (b) The unearned premium could provide a measure that is obtainable with less cost and effort, either as a separate measurement approach or as a proxy for another measurement approach. During the pre-claims period of short-term contracts, an insurer is unlikely to become aware of events that could cause significant changes in the expected cash flows. If significant changes do occur in such a short period, they are likely to be adverse changes and a liability adequacy test should capture them.
- (c) However, if one wants to use the unearned premium as a measurement approach for a certain type of contracts, a line needs to be drawn between the unearned premium approach and the approach based on building blocks. Some would suggest drawing the line between life and non-life, but another alternative would be to draw the line between short-duration and long-duration contracts.
- (d) The DP took the position that an insurer should not assume the unearned premium to be a reasonable approximation to a building block approach without testing it, particularly if a contract is likely to be highly profitable or highly unprofitable, or

Is unearned premium a measurement attribute?

44. Staff believes that unearned premium (candidate 5) can be an attribute of the insurance liability. However, the attribute would need to be characterised based on a customer consideration approach rather than a prospective model based on current estimates.

Why not a separate measurement approach for claims liabilities of non-life contracts?

45. In the DP the Board took the preliminary view that discounting is appropriate for all insurance liabilities, including non-life claims liabilities. Some respondents suggested that, as a consequence of significant differences between life and non-life contracts, the claims liability for non-life contracts should be based on undiscounted claims with no risk margin. See appendix A to this paper for one of the most detailed descriptions of those differences. The arguments brought forward in the comment letters are consistent with the arguments against discounting mentioned in the DP. Appendix B to this paper reproduces extracts from the DP that give more detail on arguments on discounting and risk margins for non-life claims liabilities, both for and against.

46. However, the DP took the position that discounting could have a material effect for claims liabilities⁸. Furthermore, the DP also takes the position that, in order to convey decision-useful information about the uncertainty associated with future cash flows, insurance liabilities should include a margin. Staff therefore believes that the claims liabilities should be measured in accordance with one of the candidates based on a building block approach.

The next steps

47. The Board's preferences on the key decision points discussed in paragraphs 23-33 will help it select the measurement approach for insurance contracts. Based on the list provided in this paper, one needs at least to select one of the candidates that are based on a building block approach (candidates from 1 through 4). One can, based on the discussion in paragraphs 41-44, also choose to apply candidate 5 for short-duration contracts as either a separate measurement approach or as a proxy for one of the other four candidates.

⁸ As explained in paragraph 8 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, discounting would not be required when its effect is immaterial.

48. After this educational session we will seek feedback on the candidates from the Insurance Working Group meeting in November 2008. At a subsequent meeting, we will ask the Board to reach a conclusion on the measurement approach.

Questions for the Board

49. **Do you need more information on the candidates?**

50. **Have you identified any other candidates the Board should consider?**

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:

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