



Project **Insurance Contracts**

Topic **Measurement approach for Insurance contracts**

Purpose of this paper

1. At the July Joint Board meeting, staff will ask the boards to conclude on the measurement approach for insurance contracts. In preparation for that meeting, staff will ask each Board to take an indicative vote on the candidate measurement approaches at the July 21 FASB meeting and the July 22 IASB meeting.
2. This paper discusses the measurement approaches that could be selected for all insurance contracts. When discussing these measurement approaches with the boards, staff will focus on the main features of both models. It will be beyond the purpose of the July meetings to fill in all the details of the models, including detailed guidance.
3. Agenda paper 11B discusses whether an unearned premium approach could be used for pre-claims liabilities of short-duration contracts; we do not discuss the unearned premium approach in this paper.
4. At the July IASB meeting¹, the IASB's IAS 37 project team proposes additional measurement guidance to further clarify the measurement approach being developed in the project to amend IAS 37 *Provisions, Contingent Liabilities and*

¹ July 2009, agenda paper 8A.

This paper has been prepared by the technical staff of the FAF and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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Staff paper

Contingent Assets (the updated IAS 37 model)². The appendix to this paper sets out how the latest staff recommendations (included in the July IAS 37 papers) could work for insurance, as a follow-up on the analysis of the updated IAS 37 included in the June papers³. [We note that if the IASB comes to a different conclusion on the July 2009 IAS 37 proposals, our analysis of how to apply the updated IAS 37 model to insurance could change significantly.]

5. The table in agenda paper 11C compares the measurement candidates we consider for selection at the July meetings.

Summary of staff recommendations

6. In this stage, IASB staff recommends that the IASB should select the updated IAS 37 model (modified to exclude day one gains) as the measurement approach for insurance contracts.
7. FASB staff are still undecided in anticipation of the forthcoming measurement discussions with the FASB in preparation for the July joint meeting.
8. We will update staff recommendations after the boards had their preparatory meetings (July 21 and July 22) in order to reach a joint staff recommendation for the joint meeting at July 23.

Structure of the paper

9. The rest of this paper is divided into the following sections:
 - (a) The candidates (paragraphs 11-14)
 - (b) The similarities between the candidates (paragraphs 15-23)
 - (c) The differences between the candidates (paragraphs 24-31)
 - (d) Feedback from the Working Group (paragraph 32)
 - (e) Selecting one of the candidates (paragraphs 33-36)
 - (f) Treatment of the residual and composite margins (paragraphs 37-50)

² The FASB will have an educational session on IAS 37 on July 14. This educational session will also address measurement.

³ See June 2009, agenda paper 10B.

Staff paper

10. This paper does not deal with:
- (a) a detailed discussion of whether a measurement of insurance contracts should include a risk margin. [For the IASB this issue in effect is part of the analysis of the IAS 37 model. The FASB will have a separate discussion about risk margins on July 21];
 - (b) detailed measurement guidance, such as estimating the expected cash flows and discount rates;
 - (c) non-performance risk. The staff believes a discussion of this issue now might prejudice the outcome of the deliberations around IASB's discussion paper *Credit Risk in Liability Measurement*, for which comments are due on 1 September;
 - (d) whether an insurer should account for insurance contracts as a single (net) asset or liability, or account for future cash outflows as a liability and future cash inflows as an asset.

The candidates

11. Based on discussions in previous meetings, staff presents in this paper the following candidates for selection as the measurement approach for insurance contracts (in no particular order).
- (a) a measurement approach based on the measurement approach being developed in the project to amend IAS 37 (the updated IAS 37 model).
 - (b) a current fulfilment value that includes a composite margin [though the FASB may want to consider a variation of this approach that includes a prescribed risk margin based on a principle that still has to be determined].
12. In the June papers, staff proposed the following changes to the list of candidates:
- (a) to include the updated IAS 37 model;
 - (b) remove the current fulfilment value with a margin for cost of bearing risk and a residual margin;
 - (c) for the IASB, to remove current exit price.
13. At its June meeting, the IASB agreed with these changes and thereby confirmed the candidates listed in paragraph 11.

14. The FASB has yet to discuss the proposed changes in paragraph 12. The staff will ask the FASB to discuss those changes at the meeting on 21 July as part of the discussion leading up to an indicative vote on the candidates in that meeting. Nevertheless, staff believes the candidates for FASB consideration can be presented as listed in paragraph 11 without prejudging the outcome of FASB's discussions.

The similarities between the candidates

15. Based on the discussions and tentative decisions so far, the updated IAS 37 model and the current fulfilment value have a number of common features:
- (a) The measurement perspective (paragraph 16)
 - (b) The building block overlay (paragraphs 17-18)
 - (c) Financial market variables (paragraphs 19-20)
 - (d) Cash flows (paragraph 21)
 - (e) Day one gains (paragraphs 22-23)

The measurement perspective

16. Both the updated IAS 37 model and the current fulfilment value measure the insurance liability from the perspective of the insurer, not from the perspective of a market participant.

The building block overlay

17. The IASB has decided tentatively that the measurement for an insurance liability will use the following three building blocks:
- (a) current estimates of (expected, ie probability-weighted) future cash flows;
 - (b) time value of money;
 - (c) an explicit margin.
18. The FASB has decided tentatively to include (a) a current estimate of the expected (ie probability weighted) present value of future cash flows, but has yet

to discuss whether the measurement includes (b) time value of money and (c) an explicit margin. FASB will be discussing those items either on or before 21 July.

Financial market variables

19. The measurement approach should consider all available information. In this context, the IASB specified that the measurement should use estimates of financial market variables that are as consistent as possible with observable market prices. The FASB clarified that all available information includes, but is not limited to, industry data, historical data of an entity's costs, and market inputs when those inputs are relevant to the fulfilment of the contract. [Staff's working premise is that differences (if any) between these two decisions should be dealt with at the stage of drafting the measurement guidance for the exposure draft.]
20. In most cases, both the updated IAS 37 model and current fulfilment value would measure the liability by looking at fulfilment of the insurance obligation over time. As a result of the guidance in paragraph 19, we do not expect a difference between the candidates in relation to financial market variables like discount rates. Moreover, even if under the IAS 37 model a transfer value or settlement value would become relevant, one would expect those values to build on the same financial market variables as a fulfilment value.

Cash flows

21. Both the updated IAS 37 model and a current fulfilment value use the expected (ie probability-weighted) present value. Both models also measure these cash flows from the perspective of the insurer and therefore do not exclude cash flows specific to the insurer. In most cases, we do not expect a difference in estimates of expected cash flows; paragraph 29 specifies the cases where a difference could exist.

Day one gains

22. The boards have decided tentatively that an insurance measurement should not lead to the recognition of positive day one differences in profit or loss (ie day one gains) [the IASB decided tentatively to limit revenue at inception to incremental acquisition costs; the FASB tentatively decided that the insurer should not recognise any day one revenue].
23. Considering that insurance contracts are with customers (ie policyholders), both candidates are going to be hybrid approaches of:
 - (a) a current measure, either the updated IAS 37 model or current fulfilment value; and
 - (b) an allocation model for residual and composite margins [paragraphs 37-50 deal with this].

The differences between the candidates

24. In this section we analyse the differences between the updated IAS 37 model and the current fulfilment value by considering a number of topics:
 - (a) Precedents from existing standards and other projects (paragraphs 25-26)
 - (b) The measurement objective (paragraphs 27-28)
 - (c) Service activities (paragraph 29)
 - (d) Risk margins (paragraphs 30-31)

Precedents from existing standards and other projects

25. The updated IAS 37 model finds its precedent in the IASB's project to amend IAS 37. In that context it is quite natural for the IASB to consider, and perhaps select, for insurance contracts a measurement that will be used for other types of uncertain liabilities. It is perhaps less natural for the FASB to consider adopting the updated IAS 37 model because it has not used IAS 37 before and did not participate in the IAS 37 project.

Staff paper

26. Current fulfilment value has been developed within the insurance project as a candidate. It does not have a precedent in other existing standards or projects. The staff see no obstacle within the Board's Frameworks that would preclude the use of this objective.

The measurement objective

27. The measurement objective of the IAS 37 project builds on the amount an insurer would rationally pay to be relieved of an obligation. Although this objective acknowledges that insurers typically fulfil their insurance liabilities, it also specifically takes into account cases where there is objective evidence of a transfer or settlement amount.
28. The objective of current fulfilment value is to measure the expected present value of the cost of fulfilling the obligation to the policyholder over time. This definition was preferred by many respondents to the DP because it is as close as possible to how insurers typically conduct their business.

Service activities

29. In the case of service activities, the updated IAS 37 model requires the insurer to use what a subcontractor would charge to undertake the services. In absence of an efficient market, the insurer could estimate this amount based on what the insurer would charge to another party to undertake those services. This amount would include the profit the insurer would require for those services (a service margin). This may result in a difference from the cash flows used under a current fulfilment value, which does not necessarily include such a requirement.

Risk margins

30. The IAS 37 measurement objective provides a basis for both risk and service margins (if any). The risk margin includes the value to the entity of having to bear the risk inherent in the cash flows. It reflects the fact that an insurer would rationally pay different amounts to be relieved of two liabilities that differ in riskiness but are otherwise the same.

31. Staff has been unable to find a definition for margins, both risk and service, that flows directly from the definition of current fulfilment value. The fulfilment candidate currently included in the list therefore does not include a separate risk margin. However, a variation to this approach could be to include in a current fulfilment value a prescribed risk margin based on a principle still to be determined.

Feedback from the Working Group

32. At the June 2009 Working Group meeting, staff received at a high level the following feedback on the candidates:
- (a) Working group members generally preferred a measurement approach for insurance contracts that considered the fact that insurers typically fulfil their obligations with the policyholder over time.
 - (b) Most working group members understood the rationale for considering the updated IAS 37 model as one of the candidates, particularly from the IASB's perspective. However, some commented that they would need further clarification on that model before they could determine how it would work out for insurance contracts and, as a result, considered it premature to remove a current fulfilment value with a margin for the cost of bearing risk (former candidate 3) from the list.
 - (c) Some working group members believed that an insurance measure should include a risk margin that is measured separately. Others preferred one single composite margin. Working group members generally expressed concerns that identifying a separate service margin would add unnecessary complexity to an insurance measurement.

Selecting one of the candidates

33. In paragraphs 24-31 we analysed the differences between the two candidates considered in this paper. Based on these differences, we identified arguments for each of the two candidates.
34. Arguments in favour of the updated IAS 37 model are:

Staff paper

- (a) It builds on a precedent from another project that also deals with uncertain liabilities, namely IAS 37. This reduces complexity and the need for industry-specific guidance. [Although staff acknowledges that this argument is less relevant for the FASB because IAS 37 is not part of its existing standards or any of the projects it is undertaking at this stage].
 - (b) The updated IAS 37 looks at what someone would pay or charge as opposed to simply ‘computing’ a number. Arguably, its measurement objective therefore provides a more rigorous basis for resolving new and emerging issues than a current fulfilment value; particularly if a current fulfilment value is defined in a way that includes an explicit risk margin.
 - (c) The updated IAS 37 model provides a basis for risk and service margins; they flow from the objective. If the boards wish to include risk and/or service margins in a fulfilment model, they will need to specify the basis for these margins as an additional component because they would not flow naturally from the definition of current fulfilment value.
35. Arguments in favour of current fulfilment value are:
- (a) A current fulfilment value is as close as possible to how insurers typically conduct their business and rules out any hypothetical market notions as much as possible. Some of the guidance on the updated IAS 37 model, for example the guidance around subcontractors’ cash flows, may also bring some hypothetical market elements into the measurement.
 - (b) As currently defined, it does not include risk and service margins that are separately identified and updated. Such margins add unnecessary complexity and often can only be determined in an arbitrary way.
 - (c) The updated IAS 37 model is bound to the measurement guidance developed in the IASB’s IAS 37 project (presuming that one wants to stay as consistent as possible). In contrast, a current fulfilment value allows the IASB and FASB to tailor the measurement approach to reflect the specific characteristics of insurance contracts.
36. Considering the arguments in paragraphs 34 and 35:
- (a) IASB staff recommends that the IASB should select the updated IAS 37 model (modified to exclude day one gains) as the measurement approach for insurance contracts, particularly for reasons of

Staff paper

consistency with the measurement of liabilities that are accounted for under IAS 37.

- (b) FASB staff are still undecided in anticipation of the forthcoming measurement discussions with the FASB in preparation for the July joint meeting.

Question for the boards

Based on the arguments in paragraphs 34 and 35, which candidate do you prefer?

Treatment of the residual and composite margins

37. Both the updated IAS 37 model and the current fulfilment model are modified to exclude day one gains from being recognised in profit or loss at inception. To achieve this, the measurement of the liability at inception includes the difference (if any) on day one between:
- (a) the expected present value of premiums [IASB: premium less acquisition costs], and
 - (b) the obligation from
 - (i) [in case of the updated IAS 37 model] the expected present value of the future cash outflows plus the risk and service margin that flow from the amount the insurer would rationally pay to be relieved of the obligation; or
 - (ii) [in case of the current fulfilment model] the expected present value of the future cash outflows included in the current fulfilment value.
38. Staff uses **residual** margin as a working title for the difference between (a) and (b)(i). The working title for the difference between (a) and (b)(ii) is **composite** margin. We selected these terms mainly so that we could distinguish the two types of margin in this discussion. We do not necessarily expect to use these particular terms in the exposure draft. We mentioned earlier that particularly the FASB may want to consider a variation of a current fulfilment value that includes a prescribed risk margin; in that case a day one difference would also be a residual rather than a composite.

Staff paper

39. The treatment, including subsequent release, of residual and composite margins determines when they are reported in profit or loss subsequently. In this section staff describes a high-level approach for of residual and composite margins. It is beyond the purpose of this meeting to discuss the details of initial and subsequent treatment of these margins. Staff will come back to a more detailed discussion at a future meeting, including examples of how these margins would run off.

Initial recognition

40. Paragraph 37 explained that a residual or composite margin should be recognised initially as the difference between the between the premium [IASB: premium less acquisition costs] and the cash outflows included in the current measure the boards select.
41. However, a premium may not be sufficient to cover the obligations. In that case the day one differences will be negative; in paragraph 37 the amount under (a) will be lower than the amount under (b). All of the proposed models currently included in the list of candidates recognise a negative day one difference (day-one loss) in profit or loss, which is consistent with the onerous contract test in the DP on revenue. The IASB already confirmed in its April 2009 meeting that an insurer should recognise a day-one loss in profit or loss. The FASB has not discussed this issue yet.

Subsequent release to the income statement

42. The residual and composite margins will be released to income at subsequent reporting dates. Residual and composite margins are blends. It therefore does not seem useful to update those margins for anything other than:
- (a) release of the margin for performance under the contract during the period;
 - (b) perhaps changes in estimates of variables [paragraphs 46-50 discuss this issue in more detail].

43. Arguably, the subsequent release of residual and composite margins is therefore an allocation of the residual or composite margin determined at inception, perhaps adjusted for subsequent changes in estimates. It seems natural to select a driver for their release that best reflects the characteristics of these margins. However, residual and composite margins are blends; it may not always be straight-forward to select an appropriate driver:
- (a) For a composite margin, risk is probably a dominant component. It therefore seems natural to select release from risk. However, other drivers like expected benefit payments (ie cash outflows) could also be considered.
 - (b) A residual margin does not include a risk component because that component is included in a separate risk margin. It therefore seems less straight-forward to select release from risk as the driver for a residual margin. Other drivers like expected premium receipts or claim payments could be considered. But if no other driver is available, perhaps release from risk could be used.
44. One particular issue for release of a residual or composite margin is to determine the period over which they should be released:
- (a) one approach is to apply the full term of the liability, covering both pre-claims and a claims period. This is probably the only approach that can be applied if one uses release from risk over the life because the insurer is not fully released from risk before claims are paid.
 - (b) another approach is to release the residual or composite margin fully during the coverage (ie pre-claims) period. This approach might be appealing where the driver is something other than the release from risk. We note that under the IAS 37 model an insurer would still report income during the claims period as a result of the release of the risk and service margins.
45. This issue is particularly relevant to non-life contracts because the claims handling period may stretch significantly beyond the end of the coverage period. For life contracts the claims period typically is very short; both approaches in paragraph 44 would probably end up in an answer that is very similar.

Changes in estimates versus residual and composite margins

46. Consider the following highly simplified example:

Insurer A enters into an insurance contract on January 1, 2010. For simplicity, we ignore risk so it is not relevant whether the measurement includes a separate risk margin. As a result, in this example the residual and composite margin will be the same; this normally would not be the case. The premium is CU100 and is received at inception. The expected present value of the claims is CU80. As a result the [residual/composite] margin at inception is CU20.

Suppose that on January 2, 2010, the insurer increases its expected cash flows from CU80 to CU 90. For simplicity, we ignore any amounts the insurer would release to the income statement from January 1 to 2.

47. From this example, we identified three approaches to address the subsequent changes in [residual/composite] margins:
- (a) The margin is updated subsequently as a fixed proportion of the expected cash flows, determined at inception. This results in a liability on January 2 of CU112.5, consisting of cash flows of CU90 and a margin of CU 22.5 ($CU90 * CU20 / CU80$). The income statement shows an expense of CU12.5.
 - (b) The margin remains locked-in at its amount determined at inception. This means that the liability at January 2 is CU110, consisting of expected cash flows of CU90 plus a margin of CU20. The changes in cash flows of CU10 are recorded as an expense in the income statement.
 - (c) The margin is adjusted for the changes in cash flows. The liability at January 2 is therefore CU100; expected cash flows of CU90 and a margin of CU10. Consequently, no charge is recognised in the income statement.
48. The approach under (a) in effect remeasures the residual or composite margin in proportion to the premium. However, we do not see remeasuring a margin that is a blend of things as useful. Furthermore, under this approach the total [residual/composite] margin on January 2 ends up at an amount that is higher than implied by the actual premium at inception. Staff finds it difficult to argue why a component of the margin that aims at eliminating day one profit and allocating that amount over the life of the contract should be updated subsequently in such a way.

Staff paper

49. When bringing back this topic at a future meeting, staff therefore intends to focus its discussion on the other two approaches mentioned in paragraph 47.
- (a) Under (b) locking-in the amount at inception, the residual or composite margin would be released subsequently based on the original amount locked-in at inception. As a result of applying a current approach, the insurer reports changes in circumstances in profit and loss promptly.
 - (b) The objective of (c) adjusting for changes in cash flows is to measure the overall margin that the insurer expects to earn over the life of the contract, based on current expectations. If there is a change in the measurement of the expected cash flows plus any separately identified margins, the value of any residual or composite margin must be reassessed accordingly (presumably unless those margins become negative).
50. For the approach that adjusts the residual or composite margins for changes in cash flows (paragraph 49(b)), our working premise is that it would apply only to changes in estimates other than (financial) market variables. Changes in (financial) market variables would be recognised immediately in profit or loss (or other comprehensive income), together with changes in the carrying amount of the assets backing the insurance liabilities; not doing so would result in an accounting mismatch if the assets are measured at fair value.

Question for the boards

Do you agree at a high level with staff's approach to residual and composite margins in paragraphs 37-50?

APPENDIX – Follow-up on the updated IAS 37 model for Insurance

- A1. In the June papers, staff explained how the updated IAS 37 model could be applied as a measurement basis for insurance contracts. During discussions at the June IASB meeting Board members noted that it probably would be necessary to specify the measurement objective of IAS 37 in more detail if it were to be used for other types of liabilities, such as those arising from insurance contracts. Staff received similar comments during the June 2009 Insurance Working Group.
- A2. In their July papers⁴, staff on the IASB's IAS 37 project discusses the measurement guidance for the updated IAS 37 model. This appendix discusses, as a follow-up on the analysis of the updated IAS 37 model included in the June papers⁵, how the staff proposals in the July IAS 37 paper could work for insurance. In this appendix we focus on the staff recommendations in that paper.

The staff recommendation

- A3. In their July paper, staff on the IAS 37 project recommends that the amount the entity 'would rationally pay' is the *maximum* amount that it would rationally be *willing* to pay. This amount is the lowest of:
- (a) the value to the entity of not having to fulfil the liability (an entity-specific measure);
 - (b) the price that the market would demand to assume the liability; and
 - (c) the price that the counterparty would demand to cancel the liability, if cancellation is possible.

⁴ July 2009, agenda paper 8A.

⁵ See June 2009, agenda paper 10B.

Staff paper

- A4. In theory, all three amounts could be relevant in the case of insurance and need to be measured to identify the lowest one. However, in practice, the exercise might not be as onerous (or hypothetical) as it appears. It could be argued that:
- (d) typically, there is no market for insurance liabilities. Therefore, it is unlikely that there will be evidence to support any estimate of a market transfer price that is lower than the insurer's own estimates based on fulfilment.
 - (e) similarly, an insurer cannot usually cancel an insurance obligation for less than the value of fulfilling it. Otherwise, it would rationally already have done so, or at least have started the process of doing so. So a cancellation price from a commutation⁶ would need to be considered only if there is objective evidence of a commutation being a realistic possibility in practice.
- A5. The above measurement requirements could be explained as the amount at which the insurer would be indifferent between keeping the obligation on the books to fulfil it over time itself and transferring or settling the obligation immediately. Therefore, the measurement requirements are a measure of 'value', not necessarily of 'cost', and translate into the building blocks for an insurance measurement as discussed below.

Cash flows

- A6. The value to an insurer of not having to fulfil an obligation does not exclude cash flows that are specific to the insurer; it is a measurement from the entity's perspective. In estimating the maximum amount it would be willing to pay, an insurer would also consider both direct costs and indirect costs associated with fulfilling that obligation.
- A7. In some cases the insurer provides services as part of an insurance contract that could also be provided on a stand-alone basis, eg. fund management services or

⁶ Settling the obligation with the counterparty means extinguishing the obligation by paying the counterparty on the measurement date; for an insurance contract, such a transaction is often known as a commutation. We distinguish commutations from cancellations that arise from contractual terms, such as surrenders by policyholders.

car repairs. Under the updated IAS 37 model, the measurement of the insurer's liability would include the cash flows and the related profit margin (the service margin, see paragraph A10) a contractor would require for undertaking such a service. If there is no efficient market for such services, the measurement would include the profit the insurer would itself require for providing such services.

Margins

- A8. We identified two margins that flow from the IAS 37 measurement objective:
- (f) a risk margin;
 - (g) a service margin (if any).
- A9. If applied to insurance liabilities, the updated IAS 37 model requires a risk margin. The risk margin is the value to the entity of not having to bear the risk in the expected cash flows. The riskier a liability is, the more an insurer would rationally pay to be relieved of it (all other things being equal). The risk margin would reflect the amount at which an insurer would be indifferent between keeping a risk and transferring or settling the risk immediately. One useful source of inputs for estimating the risk margin might be the pricing on the reinsurance market.
- A10. In estimating the amount it would rationally pay to be relieved of service activities, the insurer would include the profit it requires for undertaking those services in a margin for other services (see paragraph A7). One way of estimating this service margin could be the stand-alone selling price the insurer charges for a service.

Time value of money

- A11. Timing of the cash flows will affect the amount the entity would be willing to rationally pay; time value of money will therefore be included in the measurement. Although the updated IAS 37 model includes time value of money, the measurement requirements in IAS 37 will probably not provide specific guidance on the discount rate.

A residual margin component

A12. The updated IAS 37 model does not explicitly deal with revenue-generating contracts with customers. Because insurance contracts are such contracts, we will have to consider some issues not addressed in the current draft of the updated IAS 37 model. One of those issues is how to eliminate day one differences; one obvious way would be to include the day one differences in a residual margin like the one considered in one of the fulfilment candidates. Paragraphs 37-50 of this paper discuss a high-level approach for the treatment for residual margins.

The alternative view

- A13. The alternative view set out in the July 2009 IAS 37 paper considers the amount the entity would rationally pay to be relieved of the present obligation as the minimum amount that the entity would have to pay.
- A14. This alternative view focuses on the amount that the counterparty would demand to cancel the obligation or a third party would demand to assume the obligation. Under this view, an insurer would have to estimate the amount that a third party would demand to assume the obligation.
- A15. If the measurement guidance for the updated IAS 37 is based on this alternative view, we expect that our analysis in this appendix on the application of the IAS 37 model for insurance could change significantly.