Project **Insurance contracts**

Topic **Current exit price**

Staff note

This paper on current exit price for insurance contracts has the same content as agenda paper 10C for the June 2009 IASB and FASB meetings. The questions for participants on candidate measurement approaches are included in agenda paper 6 for the June 2009 Working Group meeting

Purpose of this paper

1. This paper considers whether the IASB Board should retain current exit price (modified to exclude day one gains) as one of the candidate measurement approaches for insurance contracts.

Summary of staff recommendations

2. This paper argues that the IASB should not explore current exit price any further in this project and, thus, should remove this measurement approach from the list of candidates.

3. The rest of this paper is divided into the following sections:

   (a) background (paragraphs 4-5)

   (b) current exit price versus the IAS 37 model (paragraphs 6-10)

   (c) Do we need both candidates for insurance contracts? (paragraphs 11-17)

Background

4. In February, the IASB did not reach a clear consensus on what the objective for the measurement approach should be. The list of candidates for the IASB currently includes a candidate that uses a current exit price, supplemented with a

residual margin that prevents the recognition in profit or loss of a day one gain (if any), but does not prevent the recognition of a day one loss (if any). [When staff uses 'current exit price' in this paper, it refers to the candidate measurement approach for insurance contracts that is based on a current exit price modified to exclude day one gains].

5. On February 26, 2009, the FASB decided not to explore a current exit price approach for insurance contracts.

Current exit price versus the IAS 37 model

6. In February 2009, staff laid out both the arguments for a current exit price and the arguments for a current fulfilment value[1] (see the appendix to this paper). The essence of the arguments for a current exit price was:

   (a) current exit price is an attribute of the liability with a clear measurement objective, whereas current fulfilment value is, arguably, merely a computation.

   (b) a basis other than current exit price could result in recognising an entity's efficiencies at inception of the contract.

7. In agenda paper 10A, the staff argues to consider as a candidate for insurance contracts a measurement approach based on the model being developed in the project to amend IAS 37 (the updated IAS 37 model).

8. The updated IAS 37 model would apply a measurement approach that measures the amount that the entity would rationally pay to be relieved of the obligation. The staff believe that amount is an attribute of that obligation and provides a clear principle for determining the features of the model. In other words, current exit price and the updated IAS 37 model both are attributes of the liability with a clear measurement objective; neither of the models is preferable to the other in that respect.

9. The updated IAS 37 model would, in contrast to a current exit price, include the insurer's efficiencies and inefficiencies; that is an outcome of the objective of the IAS 37 measurement. However, that measurement would include only those

[1] February 2009, agenda paper 10A, paragraphs 13 and 14.

efficiencies and inefficiencies the insurer would consider in the amount it would rationally pay to be relieved of the obligation (as opposed to the amount a market participant would require to take over that obligation).

10. For both insurance contracts and liabilities within the scope of IAS 37, there is typically no efficient market for transferring the obligation or no external party to outsource the activities from that obligation to; often those liabilities are fulfilled over time with the counterparty. Furthermore, the outcome of both liabilities measured under IAS 37 and insurance contracts is uncertain in many cases.

Do we need both candidates for insurance contracts?

11. Insurance contracts generally cannot or will not be transferred; there is no active secondary market for insurance contracts. Rather, most insurance contracts are fulfilled over time. In terms of the fair value measurement project, such liabilities are likely to be classified as 'level 3' liabilities.

12. Both current exit price and the updated IAS 37 model can deal with 'level 3' liabilities by measuring the obligation through a building block approach. However, as mentioned before, current exit price would use the perspective of market participants as the frame of reference, whereas IAS 37 would use the perspective of the entity.

13. If one decides to use the latter (perspective of the entity) for one type of uncertain liabilities (liabilities accounted for under IAS 37), one would expect it to be used also for another set of uncertain liabilities (insurance contracts). So far, we have not identified any reason why a different approach should apply to these two types of uncertain liabilities.

14. The only thing we have identified so far that could conceivably justify a different approach is the fact that the IAS 37 generally does not deal with contracts with customers, whereas insurance contracts are contracts with customers. However, we did not see how this difference could make the IAS 37 approach unsuitable for insurance contracts [we refer to agenda papers 10A and 10B for a more detailed discussion on this].

15. Of the two candidates, staff therefore sees the IAS 37 model as preferable to current exit price for insurance contracts.

16. In addition, the boards rejected a current price approach as a measurement approach for contracts with customers in the DP on revenue.

17. Staff therefore recommends not to pursue a current exit price any further as the measurement approach for insurance contracts.

Question for the Board
Do you agree with the staff's recommendation not to pursue current exit price any further as a candidate measurement approach for insurance contracts?

Appendix – Arguments for and against a current exit price approach

Paragraphs 13 and 14 of agenda paper 10A, February 2009

13. The arguments for current exit value[2] are:

(a) It includes all the features mentioned in paragraph 6 [of paper 10A, February 2009, which proposed that a measurement for insurance contracts should:

(i) use estimates that are as consistent as possible with observable market prices;

(ii) use explicit current estimates of the expected cash flows;

(iii) reflect the time value of money;

(iv) include an explicit margin.]

(b) A notion based on transfer provides a clear measurement objective that gives a frame of reference (market consistency) for all estimates. It also provides a clear principle for which cash flows to include (once we have decided how to define the boundaries of the item we are measuring; a subject we will return to when we talk at a future meeting about policyholder behaviour, future premiums and participating contracts).

(c) It is an attribute of the liability; some may view other candidates as the results of computations rather than as attributes. Furthermore, Phase C, Measurement, of the Conceptual Framework Project could conclude that measurements should always be attributes. Some believe that measurements should be attributes of the insurance liability because:

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[2] In agenda paper 10A of February 2009 we tentatively used the label current exit value, which was also used in the discussion paper *Preliminary Views on Insurance Contracts.* In subsequent meetings, we used the label current exit prices because both SFAS 157 *Fair Value Measurements* and the IASB's exposure draft *Fair Value Measurement* define fair value as current exit price.

(i) attributes provide coherent framework for resolving new and emerging issues.

(ii) using an attribute may make it easier to communicate with users. Users often complain that insurance accounting is a 'black box'.

(d) Most of an insurer's assets are measured at fair value under both IFRSs and US GAAP. Adopting the same measurement attribute for insurance liabilities would substantially reduce accounting mismatches and may more effectively reveal economic mismatches. Moreover, if current exit value and a competing notion (eg. fulfilment value) come up with identical or very similar answers, it may be more understandable to use one single label rather than two different labels.

(e) A basis other than exit notion, particularly a fulfilment notion, could result in recognising an entity's efficiencies at inception of the contract. Some believe that these efficiencies should be recognised as the entity realises them over time.

14. However, there are some arguments against current exit value:

(a) Insurers generally cannot or will not transfer the liability. Many respondents see current exit value as not relevant as it refers to a hypothetical transaction that does not reflect the way the insurance contracts are managed.

(b) Estimates of current exit value exclude entity-specific cash flows. However, most respondents to the DP believe that the most relevant measure of the liability uses the estimates and cash flows of the insurer 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 generally not possible to observe directly what cash flows would arise for market participants. 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 result from different levels of service provided and the approach to claims management. Adjusting the entity's own expenses could lead to inconsistency with other estimates like mortality and lapses.

(c) An exit notion of a liability reflects its credit characteristics. Most respondents reject this notion because it could lead to income or expense that they believe is difficult to understand; particularly when the liability is remeasured.

(d) The boards have tentatively rejected an exit notion in the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (DP on revenue). Some believe that measurement of insurance contracts should be as consistent as possible with that tentative decision. Some are particularly concerned about inconsistencies between the approach for insurance contracts and the approach for other services provided by insurers, such as fund management. Many life insurers offer fund management services both separately and embedded in insurance contracts.