

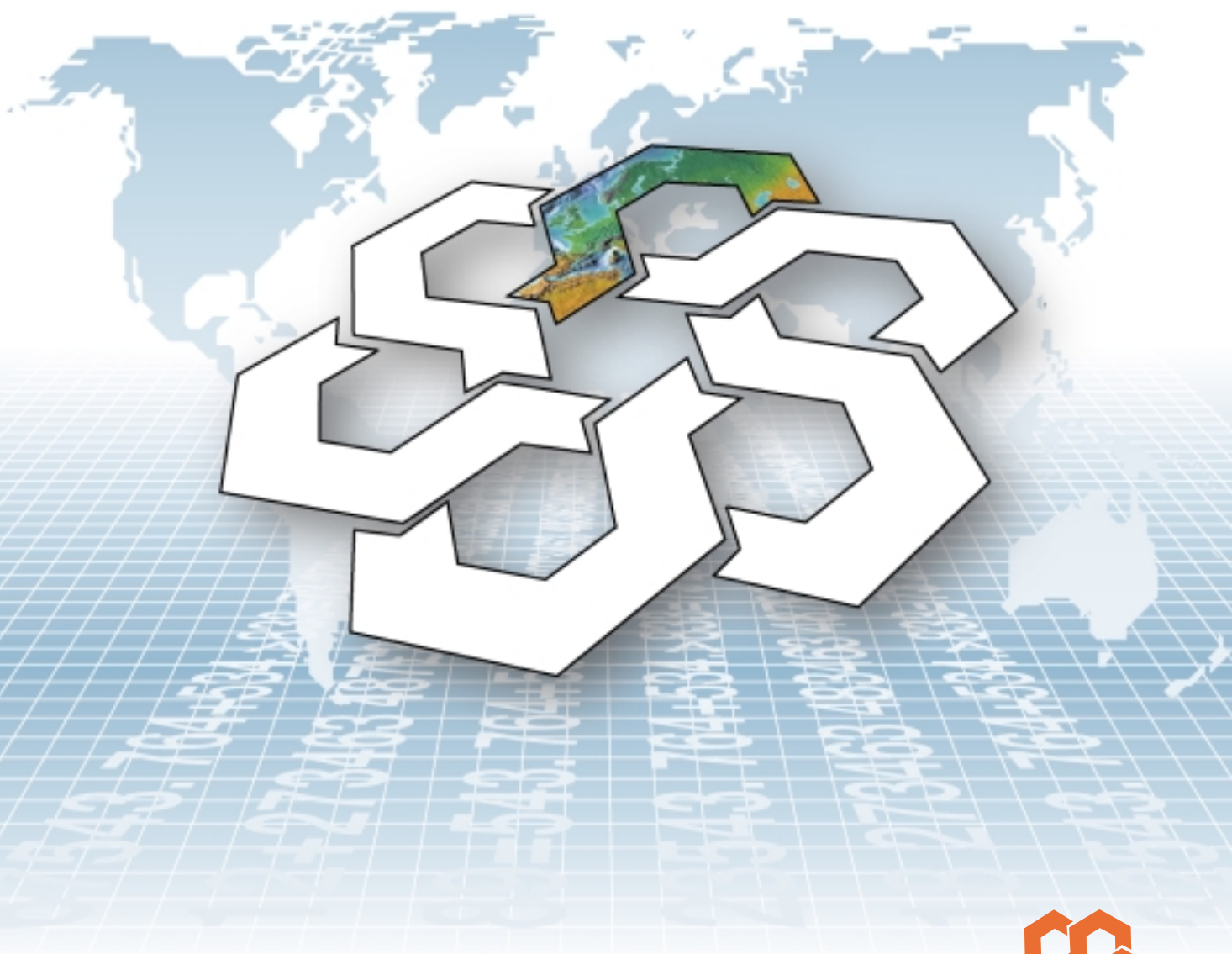
May 2007

DISCUSSION PAPER

Preliminary Views on Insurance Contracts

Part 1: Invitation to Comment and main text

Comments to be submitted by 16 November 2007



International
Accounting Standards
Board®

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**Preliminary Views
on
Insurance Contracts**

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This Discussion Paper *Preliminary Views on Insurance Contracts* is published (in two parts) by the International Accounting Standards Board (IASB) for comment only. Part 1 contains the Invitation to Comment and the main text. Part 2 contains the Appendices.

Comments on the contents of the Discussion Paper should be sent in writing so as to be received by **16 November 2007**. Respondents are asked to send their comments electronically to the IASB Website (www.iasb.org), using the 'Open to Comment' page.

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CONTENTS

CONTENTS

paragraphs

PART 1

Invitation to Comment and main text

INVITATION TO COMMENT AND SUMMARY	IN1–IN40
Introduction	IN1–IN7
Invitation to comment	IN8–IN10
Summary of preliminary views	IN11–IN40
CHAPTER 1 BACKGROUND	1–26
Context	1–4
Process	5–6
Input from insurers and supervisors	7–8
Next steps	9–11
Convergence with US requirements	12
Scope	13–21
Insurance contracts of insurers	13
Other assets and liabilities of insurers	14
Accounting by policyholders	15
What is an insurance contract?	16–19
Types of insurance contract	20–21
Overview of the rest of this paper	22–26
CHAPTER 2 RECOGNITION AND DERECOGNITION	27–30
Recognition	27–28
Derecognition	29–30
CHAPTER 3 MEASUREMENT – CORE ISSUES	31–119
Introduction	31–33
Estimates of future cash flows	34–62
Overall objective for estimates of cash flows	34
Explicit estimates	35
Consistency with observed market prices	36–38
Unbiased use of all available information	39–43
Current estimates	44–53
Liability adequacy test	54–55
Entity-specific cash flows	56–62

Time value of money	63–70
Should the carrying amount of insurance liabilities reflect the time value of money?	64–66
Materiality	67–68
Determining the discount rate	69–70
Margins	71–89
Risk margins	72
Purpose of a risk margin	73–75
Estimating the risk margin	76–77
Calibrating the risk margin per unit	78–80
Calibration: arguments for implementation A	81
Calibration: arguments for implementation B	82
Profit at inception	83–85
Preliminary view on the risk margin	86
Service margins	87–89
Summary of the Board’s preliminary view on the three building blocks	90–91
Identifying the measurement attribute	92–115
Current entry value	96–101
Value in settlement with the policyholder	102–103
Fair value	104
Embedded value	105–110
Unearned premium	111–112
Allocated customer consideration	113–115
Summary of preliminary views in this chapter	116–119
CHAPTER 4 POLICYHOLDER BEHAVIOUR, CUSTOMER RELATIONSHIPS AND ACQUISITION COSTS	120–174
Beneficial policyholder behaviour	121–160
Background	121–128
An introductory example	129–133
Arguments for approach B (exclude policyholder behaviour that results in net cash inflows)	134
Arguments for approach C (exclude policyholder behaviour that results in net cash inflows or that reduces net cash outflows)	135
Arguments for approach D (include all policyholder behaviour relating to existing contracts)	136–137
Nature of expected benefits from beneficial policyholder behaviour	138–140
Should an insurer recognise a customer relationship as an asset?	141–142
Presenting the recognised part of the customer relationship	143–149
Boundaries of the existing contract	150–160

CONTENTS

Acquisition costs	161–166
Insurance contracts acquired in business combinations and portfolio transfers	167–172
Business combinations	167–169
Contracts acquired in a portfolio transfer	170–172
Summary of preliminary views in this chapter	173–174
CHAPTER 5 MEASUREMENT – OTHER ISSUES	175–233
Assets backing insurance contracts	176–182
Unit of account	183–202
Recognition	184
Measurement	185
Expected present value of future cash flows	186–189
Risk margins	190–191
Statistical evidence	192
Adverse selection	193–194
Random fluctuations and diversifiable risk	195–198
Defining the unit of account	199
Diversification between portfolios and negative correlations between portfolios	200–201
Summary of preliminary views on unit of account	202
Reinsurance	203–219
Reinsurance liabilities	203
Reinsurance assets	204–205
Margins for risk associated with the underlying insurance contract	206–210
Reinsurance assets: impairment	211–214
Gains and losses on buying reinsurance	215–217
Non-overlapping periods of coverage	218
Summary of preliminary views on reinsurance	219
Unbundling	220–228
Arguments for unbundling	225
Arguments against unbundling	226–227
Preliminary view on unbundling	228
Credit characteristics of insurance liabilities	229–232
Investment contracts	233

CHAPTER 6 POLICYHOLDER PARTICIPATION	234–295
Participating contracts	235–261
Background	236–238
How do participating contracts work?	239–246
Definition of a liability	247–253
Preliminary views on participating contracts	254–258
Measurement of participating contracts	259–261
Universal life contracts	262–268
Crediting rates	265–267
Future cash flows	268
Unit-linked contracts	269–286
Recognition and presentation of separate account assets	273–277
Accounting mismatches for unit-linked contracts	278–279
Recognition and measurement of separate account assets	280–281
Measurement of unit-linked liability	282–285
Preliminary view on unit-linked contracts	286
Index-linked contracts	287–288
Summary of preliminary views in this chapter	289–295
CHAPTER 7 CHANGES IN INSURANCE LIABILITIES	296–337
Are insurance premiums revenue or deposits?	297–324
Components of an insurance premium	298–300
Illustrations	301–308
A difference between life and non-life presentations	309–311
Premiums written	312–313
Premiums earned	314–315
Possible approaches	316–322
Preliminary view on insurance premiums	323–324
Changes in the carrying amount of insurance liabilities	325–328
Presentation in profit or loss	329–335
Shadow accounting	330–335
Summary of preliminary views in this chapter	336–337
TABLES	
3.1 Risk margin – two views	73
3.2 Risk margin – calibration	79
4.1 Beneficial policyholder behaviour	131
5.1 Risk margin in a reinsurance asset	206

CONTENTS

PART 2

Appendices *see separate booklet*

- A Questions for respondents**
- B Comparison with IAS 39**
- C Other relevant IASB projects**
- D Issues not covered in this Discussion Paper**
- E Estimates of future cash flows**
- F Risk margins**
- G Examples**
- H Credit characteristics of insurance liabilities**
- I Glossary**

Invitation to Comment and Summary

Introduction

- IN1 This discussion paper presents the preliminary views of the International Accounting Standards Board on the main components of an accounting model for insurance contracts. The Board formed those views in phase II of its project on insurance contracts.
- IN2 Phase I of this project resulted in IFRS 4 *Insurance Contracts*, an interim standard that permits a wide variety of accounting practices for insurance contracts. Many of these practices differ from those used in other sectors and make it difficult to understand insurers' financial statements.

Next step

- IN3 The Board will review the responses to this paper and modify or confirm its preliminary views. The Board will then use its conclusions to develop for public comment an exposure draft of an International Financial Reporting Standard (IFRS).
- IN4 In doing so, the Board will pay particular attention to the need for users of an insurer's financial statements to receive relevant and reliable information, capable of preparation at a reasonable cost, as a basis for economic decisions. The information should enable users to compare the financial position and financial performance of insurers within a country and in different countries. It should be comparable with information provided about similar transactions by entities that are not insurers.
- IN5 When the Board reassesses whether its preliminary views achieve these objectives, it will refer to its *Framework for the Preparation and Presentation of Financial Statements*. The Board will base its conclusions on the merits of the arguments for and against each alternative, not on the number of responses supporting each alternative.
- IN6 The constitution of the IASC Foundation requires the Board to consider holding public hearings to discuss proposed standards and to consider undertaking field tests (both in developed countries and in emerging markets) to ensure that proposed standards are practical and workable in all environments. There is no requirement to hold public hearings or undertake field tests for every project. When the Board reviews the responses to this paper, it will consider whether a public hearing would

INTRODUCTION

provide input beyond that provided by its Insurance Working Group. The Board does not plan to conduct field tests during the period for comments on this paper. The Board will consider in due course whether field tests would be appropriate later in the project.

Convergence with US requirements

- IN7 The US Financial Accounting Standards Board (FASB) plans to publish an Invitation to Comment containing this paper. The FASB will use the responses in deciding whether to add to its agenda a joint project with the IASB to develop a comprehensive standard on accounting for insurance contracts.

Invitation to comment

- IN8 The Board invites comments on all matters in this paper. Chapters 2-7 include questions for respondents. Appendix A lists all the questions. Comments are most helpful if they:
- (a) comment on the questions as stated
 - (b) indicate the specific paragraph or paragraphs to which the comments relate
 - (c) contain a clear rationale
 - (d) describe any alternative the Board should consider.
- IN9 Respondents need not comment on all of the questions and are encouraged to comment on any additional issues.
- IN10 The Board will consider all comments received in writing by **16 November 2007**.

Summary of preliminary views

- IN11 Chapter 1 describes the background to the project. Chapters 2-7 summarise arguments the Board considered and describes the preliminary views the Board has reached. They also contain summaries of those preliminary views, at the end of each chapter (chapters 2-4, 6 and 7) or at the end of each section (chapter 5).

- IN12 Paragraphs IN13–IN40 below provide an overall summary of the Board’s preliminary views. Except in paragraph IN20, that summary does not repeat the arguments for those views: the arguments appear in chapters 2–7.

Scope (chapter 1)

- IN13 This paper deals with insurance liabilities (an insurer’s obligations under an insurance contract) and insurance assets (an insurer’s rights under an insurance contract).
- IN14 This paper does not discuss accounting by policyholders for insurance contracts. The Board plans to address that topic later in this project.

What is an insurance contract?

- IN15 IFRS 4 defines an insurance contract as a ‘contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.’ This paper does not discuss whether that definition is still appropriate. The Board plans to consider that question in developing an exposure draft.
- IN16 The preliminary views in this paper apply to all types of insurance contract: life and non-life, direct insurance and reinsurance. They also apply throughout the life of a contract, to both the pre-claims period (ie the coverage period when the insurer is standing ready to meet valid claims) and the claims period (when the insured events have occurred but the ultimate payment is still uncertain).

Recognition and derecognition (chapter 2)

- IN17 An insurer should recognise rights and obligations created by an insurance contract when it becomes a party to the contract. An insurer should derecognise an insurance liability (or a part of an insurance liability) when it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires. Because derecognition of financial assets is a complex topic and the subject of another project, the discussion paper does not address derecognition of insurance assets.

Measurement – core issues (chapter 3)

- IN18 The Board's preliminary view is that an insurer should measure all its insurance liabilities using the following three building blocks:
- (a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows.
 - (b) current market discount rates that adjust the estimated future cash flows for the time value of money.
 - (c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).
- IN19 Several Board members believe the margin should be calibrated to the observed price for the transaction with the policyholder. In consequence, an insurer would never recognise a profit at inception. However, a majority of Board members believe the observed price for the transaction with the policyholder, although important as a reasonableness check on the initial measurement of the insurance liability, should not override an unbiased estimate of the margin another party would require if it took over the insurer's contractual rights and obligations.
- IN20 In the Board's view, a measurement using the three building blocks will provide several benefits to users of an insurer's financial statements:
- (a) relevant information about the amount, timing and uncertainty of future cash flows arising from existing insurance contracts.
 - (b) explicit and more robust estimates of cash flows and margins.
 - (c) a consistent approach to changes in estimates.
 - (d) an appropriate and consistent approach for all types of insurance (and reinsurance) contracts. This will:
 - (i) provide a coherent framework to deal with more complex contracts (such as multi-year, multi-line or stop loss contracts) and to resolve emerging issues without resorting to unprincipled distinctions and arbitrary new rules.
 - (ii) limit the need for arbitrary rules on such matters as embedded derivatives, financial reinsurance, and amendments to existing contracts.

- (e) consistency with other IFRSs that require current estimates of future cash flows in measuring financial and non-financial liabilities.
 - (f) clearer reporting of economic mismatches between insurance liabilities and related assets, and a reduction in accounting mismatches.
 - (g) consistency with observable current market prices, to the extent they are available. Such prices provide an understandable and credible benchmark for users, even though market prices are not available to support all inputs used in measuring insurance liabilities.
- IN21 An informative and concise name for a measurement that uses the three building blocks is 'current exit value'. This paper defines current exit value as the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity.
- IN22 A measurement at current exit value is not intended to imply that an insurer can, will or should transfer its insurance liabilities to a third party. Indeed, in most cases, insurers cannot transfer the liabilities to a third party and would not wish to do so. Rather, the purpose of specifying this measurement objective is to provide useful information that will help users make economic decisions.

Policyholder behaviour, customer relationships and acquisition costs (chapter 4)

- IN23 An insurer has an asset relating to its ability to derive net economic benefits from future premiums that the policyholder must pay to retain guaranteed insurability. Guaranteed insurability is a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.
- IN24 The insurer should recognise that asset, and measure it in the same way as the related insurance liability (ie at current exit value). That asset is part of a customer relationship, not a contractual asset. Nevertheless, the insurer should present that asset as part of the related insurance liability. The insurer need not separate that asset from the liability for recognition, measurement or presentation. Thus, measurement of the insurance liability would be based on estimated cash flows from both that asset and the liability.

- IN25 Some Board members disagree with the preliminary views summarised in paragraphs IN23 and IN24:
- (a) Some of them believe that an insurer should not recognise net economic benefits expected from future premiums if the insurer cannot compel the policyholder to pay those premiums.
 - (b) Some of them believe that the criterion of guaranteed insurability is open to inconsistent application and abuse. For this reason, and for reasons discussed in chapter 3, they would prohibit the recognition of a profit at the inception of an insurance contract. In their view, an insurer should recognise a customer relationship asset, measured at inception at the amount of acquisition costs incurred, to the extent those costs are recoverable.
 - (c) Some of them believe that an insurer should always present the recognised part of a customer relationship separately from an insurance liability.
- IN26 An insurer should recognise acquisition costs as an expense when it incurs them. If the insurer expects to recover acquisition costs from future premiums that policyholders must pay to retain guaranteed insurability, those premiums reduce the measurement of the liability because the insurer includes them in the recognised part of the customer relationship. If the insurer recovers acquisition costs from premiums already received, receiving that part of those premiums does not increase the measurement of the liability.

Measurement – other issues (chapter 5)

Assets held by insurers

- IN27 In this project, the Board does not intend to change existing IFRSs (eg IAS 39 *Financial Instruments: Recognition and Measurement*) for assets held by insurers, except possibly for some assets relating to unit-linked contracts.

Unit of account

- IN28 Risk margins should be determined for a portfolio of insurance contracts that are subject to broadly similar risks and are managed together as a single portfolio. Risk margins should not reflect the benefits of diversification between portfolios and negative correlation between portfolios.

Reinsurance assets

- IN29 A cedant should measure reinsurance assets at current exit value. For risks associated with the underlying insurance contract, a risk margin typically increases the measurement of the reinsurance asset and equals the risk margin for the corresponding part of the underlying insurance contract. The current exit value of reinsurance assets incorporates a reduction for the expected (probability-weighted) present value of losses from default or disputes, with a further reduction for the margin that market participants would require for bearing the risk that defaults or disputes exceed the expected value.

Splitting contracts into their components (unbundling)

- IN30 Some insurance contracts contain both an insurance component and a deposit component. An insurer should treat these contracts as follows:
- (a) if the components are so interdependent that the components can be measured only on an arbitrary basis, the phase II standard on insurance contracts should apply to the whole contract.
 - (b) if the components are not interdependent, the phase II standard should apply to the insurance component and IAS 39 should apply to the deposit component.
 - (c) if the components are interdependent but can be measured separately on a basis that is not arbitrary, IAS 39 should apply to the deposit component. The whole contract would be measured by applying the phase II standard. Consequently, the insurance component would be measured as the difference between the measurement of the whole contract and the measurement of the deposit component.

Credit characteristics of insurance liabilities

- IN31 The current exit value of a liability is the price for a transfer that neither improves nor impairs its credit characteristics. An insurer should disclose the effect of such credit characteristics at inception and subsequent changes, if any, in their effect. In practice, such effects are normally small.

Investment contracts

- IN32 Many insurers and reinsurers issue both insurance contracts and contracts that do not transfer significant insurance risk (investment contracts). Investment contracts are within the scope of IAS 39 and, in some cases, IAS 18 *Revenue*. Appendix B summarises differences between existing requirements in IAS 39 and IAS 18 and the Board's preliminary views on insurance contracts. In principle, the Board would prefer to eliminate those differences. However, the Board has not yet assessed whether that will be appropriate. Thus, this paper includes no specific proposals for such contracts.

Policyholder participation (chapter 6)

- IN33 As already noted, one building block used in measuring an insurance liability is estimates of the cash flows in each scenario. To the extent that a legal or constructive obligation exists at the reporting date, the estimated cash flows for each scenario should include an unbiased estimate of the policyholder dividends resulting from that obligation. An insurer would need to consider the guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether such an obligation exists. Such an obligation may arise when the insurer becomes a party to the participating contract, but that will depend on the facts of each case. The Board plans to finalise in 2008 a revised version of IAS 37, building on an exposure draft of 2005.
- IN34 In measuring a participating liability at current exit value, an insurer should measure asset-dependent cash flows on a basis consistent with the measurement of the underlying assets. The insurer should use option pricing techniques that capture, on a market-consistent basis, both the intrinsic value and time value of the asymmetric pay-offs resulting from the participation feature.
- IN35 These preliminary views apply equally to participating insurance contracts and participating investment contracts. They apply to participating contracts issued by both shareholder-owned insurers and mutuals.
- IN36 For universal life contracts, estimates of crediting rates in each scenario should reflect the rate that the insurer estimates it would pay in that scenario to satisfy a legal or constructive obligation that exists at the reporting date.

- IN37 For unit-linked contracts, benefits depend partly on the fair value of a designated pool of assets. Accounting mismatches could arise if those assets are not measured at fair value through profit or loss but the related liability is measured at current exit value. The Board would prefer to eliminate those mismatches, but has not yet formed a preliminary view on whether this is appropriate. Nor has it yet formed a preliminary view on the recognition and presentation of those assets.
- IN38 For index-linked contracts, the insurer is not compelled to hold the underlying assets and it could transfer the liability without a simultaneous transfer of the assets. Existing requirements in IFRSs remain appropriate for assets held to back index-linked contracts.

Changes in insurance liabilities (chapter 7)

- IN39 Profit or loss should include all changes in the carrying amount of insurance liabilities.
- IN40 In developing an exposure draft, the Board will consider whether an insurer should present premiums as revenue or as deposit receipts, and whether the face of an insurer's income statement should present separately specified components of the changes in the carrying amount of insurance liabilities. The Board has not yet formed a preliminary view on these topics.

Discussion Paper Preliminary Views on Insurance Contracts

Chapter 1 Background

Context

- 1 This Discussion Paper is the first output of phase II of a project by the International Accounting Standards Board on accounting for insurance contracts. The Board's predecessor organisation, the International Accounting Standards Committee (IASC), began a project on insurance contracts in 1997 because:
 - (a) IASC had issued no standard on insurance contracts, and insurance contracts were excluded from the scope of other relevant IASC standards (eg standards on provisions, financial instruments and intangible assets).
 - (b) accounting practices for insurance contracts are diverse, and often differ from practices in other sectors.
 - (c) users complain that it is difficult to understand insurers' financial statements.
- 2 In 1999, an IASC Steering Committee published an Issues Paper, which attracted 138 comment letters. The Steering Committee reviewed the comment letters and concluded its work by developing a report to the Board in 2001 in the form of a Draft Statement of Principles (DSOP). The Board was constituted in 2001 as successor to IASC and included this project in its initial work plan. The Board did not approve the DSOP or formally invite comments on it, but made it available to the public on the IASB's Website.
- 3 Because it was not feasible to complete the project for implementation in 2005, the Board split it into two phases so that insurers could implement some aspects in 2005. The Board completed phase I in 2004 by issuing IFRS 4 *Insurance Contracts*. The Board's objectives for phase I were:
 - (a) to make limited improvements to accounting practices for insurance contracts.
 - (b) to avoid requiring major changes that phase II might reverse. To achieve this, IFRS 4 permits most previous accounting practices for insurance contracts to continue. IFRS 4 also exempts insurers

from a hierarchy of criteria, specified in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, that an entity must use in developing an accounting policy when no IFRS applies specifically. One criterion is compliance with the the IASB's *Framework for the Preparation and Presentation of Financial Statements*, including the need for financial statements to provide relevant and reliable information. This exemption from the requirement for relevance and reliability was a highly unusual step and the Board contemplated it only as part of an orderly and relatively fast transition to phase II.

- (c) to require an insurer to disclose information about insurance contracts.
- 4 For several reasons, permitting IFRS 4 to remain in place indefinitely is not a viable option:
- (a) IFRS 4 permits too much diversity in practice. It permits many practices that are not suited to providing relevant and reliable information to users.
 - (b) Some of those practices have developed in a piecemeal fashion over many years and do not provide a coherent framework for resolving emerging issues or coping with new types of insurance contract.
 - (c) In some cases, accounting for insurance contracts has been heavily influenced by supervisory concerns. This has sometimes resulted in methods that do not distinguish clearly between an accounting question (What assets and liabilities does the insurer have?) and a management and supervisory question (What assets should an insurer hold to give sufficient assurance of satisfying its existing obligations?).
 - (d) Some existing practices are inconsistent with practices used by other entities, particularly other financial institutions, such as banks and fund managers. These inconsistencies impede comparisons between insurers and other financial institutions. They can also mean that financial conglomerates produce financial statements that are internally inconsistent.

Process

- 5 Because of other priorities, the Board suspended work on phase II in early 2003. On restarting phase II in mid-2004, the Board took a fresh look at financial reporting by insurers. To advise it on the project, the Board set up an Insurance Working Group (IWG), made up of senior financial

executives of insurers, analysts, actuaries, auditors and regulators. The IWG held eight two-day meetings between September 2004 and June 2006. Several Board members attended each IWG meeting. The Board greatly appreciates the time and energy participants in the IWG have devoted to this process and the quality of their contributions. Their comments and insights have been very helpful to the Board as it reached the preliminary views expressed in this paper.

- 6 After restarting the project in mid-2004, the Board also obtained input from 11 public educational meetings on insurance contracts (eight led by outside presenters, one led by the staff of the US Financial Accounting Standards Board (FASB) and two led by the IASB staff). The Board reached the preliminary views expressed in this paper over 12 decision-making sessions.

Input from insurers and supervisors

- 7 In developing its preliminary views, the Board considered input received from insurers and from insurance supervisors. In September 2006, representatives of various insurers presented to the Board a summary of recommendations they made in the following publications:
- (a) *Elaborated Principles for an IFRS Phase II Insurance Accounting Model*, by the CFO Forum (of about 20 major European insurers)*
 - (b) *An International Accounting Standard for Life Insurance*, by the Group of North American Insurance Enterprises (GNAIE) and four major Japanese life insurers†
 - (c) *GNAIE Extended Principles for Non-life Insurance*, by GNAIE.§
- 8 In May 2006, the International Association of Insurance Supervisors (IAIS) published *Issues arising as a result of the IASB's Insurance Contracts Project – Phase II, Second Set of IAIS Observations*,^o following an earlier set of observations issued in 2005. Although the Board's work focuses on general purpose financial statements, the outcome of this project may have implications for insurance supervisors. Financial information is a vital part of the information that supervisors use to assess solvency and capital adequacy. To the extent that the same information can meet the

* http://www.cfoforum.nl/elaborated_principles.pdf

† <http://gnaie.net>

§ <http://gnaie.net>

o http://www.iaisweb.org/060601__Second_Liabilities_Paper_final.pdf

common needs of supervisors and other users, it would be desirable for the information reported to supervisors to converge with the information reported in general purpose financial statements.

Next steps

- 9 Before beginning work on an exposure draft, the Board will review the responses to this paper and decide whether to modify or confirm its preliminary views. In doing so, the Board will pay particular attention to the need for users of an insurer's financial statements to receive relevant and reliable information, at a reasonable cost, as a basis for economic decisions. The information should enable users to compare the financial position and financial performance of insurers within a country and in different countries. It should be comparable with information disclosed about similar transactions by entities that are not insurers.
- 10 When the Board reassesses whether its preliminary views achieve these objectives, it will refer to the *Framework*. The Board will base its conclusions on the merits of the arguments for and against each alternative, not on the number of responses supporting each alternative.
- 11 Appendix C summarises important interactions with some of the Board's other projects. The Board expects that the work on insurance contracts will proceed in parallel with these other projects and will not wait for their outcome. Also, this work may generate useful inputs for those other projects.

Convergence with US requirements

- 12 The FASB plans to seek input from its constituents on the IASB's preliminary views by publishing an Invitation to Comment containing this paper. The FASB will use the comments it receives in deciding whether to add to its agenda a project to develop jointly with the IASB a comprehensive standard on accounting for insurance contracts.

Scope

Insurance contracts of insurers

- 13 This paper deals with insurance contracts (including reinsurance contracts) issued by insurers and reinsurance contracts held by insurers.

Other assets and liabilities of insurers

- 14 This project does not deal with the treatment of assets and liabilities of insurers, other than those arising from insurance and reinsurance contracts they have issued and reinsurance contracts they hold.

Accounting by policyholders

- 15 IFRSs address only limited aspects of accounting by policyholders for insurance contracts. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* addresses accounting for reimbursements from insurers for expenditure required to settle a provision. IAS 16 *Property, Plant and Equipment* addresses some aspects of reimbursement by insurers for impairment or loss of property, plant and equipment. The project will ultimately address accounting by policyholders. However, the Board does not view work on policyholder accounting as a high priority and this paper does not address it.

What is an insurance contract?

- 16 IFRS 4 defines an insurance contract as a 'contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.' Appendix B to IFRS 4 gives guidance on this definition.
- 17 The Board has not yet considered whether that definition is still appropriate. The Board plans to consider that in developing an exposure draft. At that time, the Board will benefit from input received by the FASB in its project on insurance risk transfer.
- 18 The following features are found in many, but not all, insurance contracts. The Board considered them in developing the preliminary views in this paper.
- (a) In many other industries, the costs of a product or service are known before the associated revenue. However, for insurance contracts, the revenue (ie premiums) is generally known (and received) in advance and the costs (claims and benefits) are not known until later. Some insurance contracts expose insurers to risks that will not be fully resolved for many years.
 - (b) By pooling the risks arising from a large number of similar contracts, an insurer acquires a reasonable statistical basis for making a credible estimate of the amount, timing and uncertainty

of the cash flows arising from the contracts. If the outcome of one contract is independent of the outcome on other contracts, pooling of risks also reduces the risk of random statistical fluctuations.

- (c) An insurance contract may expose the insurer to moral hazard. This is the risk that the existence of the insurance contract will increase the level of losses. For example, a policyholder may behave more recklessly than someone who is not protected by insurance. Similarly, the existence of insurance against civil liability may encourage lawsuits against the policyholder. To limit moral hazard, insurance contracts generally cover only those adverse events that are beyond the direct control of the policyholder. For similar reasons, some contracts contain features such as deductibles,^{*} or other conditions designed to reduce the possibility that the policyholder may behave in a way that increases the probability or severity of an insured loss.
- (d) In most cases, the policyholder pays a premium (single or recurring) before the coverage period. As a result, many contracts can be viewed as containing an implicit or explicit investment or deposit component. This component can be particularly important in some long-term contracts.
- (e) Longer-term contracts often grant the policyholder valuable options to continue the contract at fixed or constrained prices even if the risk has changed or to cancel the policy. Some insurance contracts contain other embedded options, such as conversion features and guarantees of investment returns. Some contracts give the insurer options to limit coverage or change premiums.
- (f) Policyholders are more likely to exercise an option if exercise is more favourable to them. For example, if a health insurance contract guarantees continued insurability over a long period, policyholders in poor health are more likely to continue to pay premiums. This tendency, known as adverse selection, means that the characteristics of a portfolio of insurance contracts are likely to deteriorate over time with an increasing concentration of policyholders who present above-average levels of risk.
- (g) For some insurance contracts, the insurer incurs significant costs to originate the contract (acquisition costs).

* A deductible requires the policyholder to pay the first part of an insured loss. The insurer pays all or part of the excess above the deductible.

- (h) Over the life of some insurance contracts, the insurer will incur significant administrative expenses and may also provide significant services in addition to collecting premiums and paying claims. The administrative costs and servicing elements are often more significant than for many exchange-traded financial instruments, although these costs may also be significant for such financial instruments as retail deposits and some loans.
 - (i) There is generally no liquid and active secondary market in liabilities and assets arising from insurance contracts. Indeed, in most cases, an insurer cannot transfer its rights and obligations under an insurance contract to another party without the consent of the policyholder, insurance supervisors or both. Market prices that are available may serve as only a crude guide to market value. Such prices often reflect other factors, such as control of a company or the value of a distribution system or potential new business.
 - (j) Some insurance contracts (participating or with profits contracts) give policyholders the right to share in the experience of the portfolio of insurance contracts, specified assets, or both.
 - (k) Policyholders may suffer a devastating loss if an insurer is unable to pay valid claims. Consequently, insurance is highly regulated in many countries.
- 19 In this paper, **insurance liability** refers to an insurer's obligations under an insurance contract; **insurance asset** refers to an insurer's rights under an insurance contract.

Types of insurance contract

- 20 The Board's preliminary views apply to all types of insurance contract: life and non-life, direct insurance and reinsurance. They also apply throughout the life of a contract, in both:
- (a) the pre-claims period (ie the coverage period when the insurer is standing ready to meet valid claims) and
 - (b) the claims period (when the insured events have occurred but the ultimate payment is still uncertain). For some non-life insurance contracts, the claims period can extend for several years. For life insurance, the pre-claims period generally extends throughout the entire life of the contract but the claims period is generally very short because there is little or no uncertainty about the payment

once the insured event has occurred, and payment generally occurs quickly.

- 21 This paper uses the following terms to describe the liabilities relating to those periods:
- (a) The **pre-claims liability** is the insurer's stand-ready obligation to pay valid claims for **future** insured events arising under **existing** contracts—the obligation relating to the unexpired portion of risk coverage. In many countries, the amount recognised for this obligation, especially in non-life insurance, is described as unearned premium or unearned premium reserve.
 - (b) The **claims liability** is the liability to pay valid claims for insured events that have **already** occurred, including claims incurred but not reported (IBNR).

Overview of the rest of this paper

- 22 Chapter 2 deals with recognition and derecognition. Chapter 3 discusses the basic building blocks of a measurement model for insurance contracts. Chapter 4 considers policyholder behaviour, customer relationships and acquisition costs. Chapter 5 reviews more details of the measurement model. Chapter 5 also explores the interaction between the measurement of assets held by insurers and the related insurance liabilities. Chapter 6 deals with policyholder participation rights. Chapter 7 considers the presentation of changes in insurance liabilities.
- 23 Chapters 2–7 contain summaries of the Board's preliminary views, at the end of each chapter (chapters 2–4, 6 and 7) or at the end of each section (chapter 5). Paragraphs IN13–IN40 of the Invitation to Comment provide an overall summary of those preliminary views.
- 24 Appendix A summarises the questions for respondents. Appendix B summarises possible inconsistencies between the Board's preliminary views on insurance contracts and existing requirements for contracts that do not transfer significant insurance risk. Those requirements are in IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 18 *Revenue*. Appendix C describes some other relevant IASB projects.
- 25 To avoid excessive detail, this paper discusses only the most significant components of an accounting model for insurance contracts. The Board will consider the more detailed issues needed to implement a model when it develops an exposure draft for public comment. Appendix D lists some of those issues.

CHAPTER 1 BACKGROUND

- 26 Appendices E and F contain draft guidance on estimates of cash flows and on risk margins, based on the preliminary views in chapter 3. Appendix G provides examples illustrating points discussed in the main text. Appendix H discusses the credit characteristics of insurance liabilities. Appendix I contains a glossary.

Chapter 2 Recognition and derecognition

Recognition

- 27 Paragraph 14 of IAS 39 states: ‘An entity shall recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument.’ In the Board’s preliminary view, that requirement is also appropriate for insurance contracts. In other words, an insurer would recognise rights and obligations created by an insurance contract when it becomes a party to the contract.
- 28 Chapter 4 discusses how this preliminary view applies when policyholders hold cancellation or continuation options.

Derecognition

- 29 IFRS 4 requires an insurer to derecognise an insurance liability (or a part of an insurance liability) when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires. The Board has identified no reasons why derecognition requirements for insurance liabilities should differ from those for financial liabilities. Consequently, the Board does not propose to change that requirement, which is similar to the requirements in IAS 39 governing derecognition of financial liabilities.
- 30 However, because derecognition of financial assets is a complex topic and the subject of another project, this paper does not address derecognition of insurance assets.

Question for respondents

Question 1

Should the recognition and derecognition requirements for insurance contracts be consistent with those in IAS 39 for financial instruments? Why or why not?

Chapter 3 Measurement – core issues

Introduction

- 31 The Board's objective is to select a measurement model that gives users useful information about the amount, timing and uncertainty of the future cash flows resulting from the contractual rights and contractual obligations created by insurance contracts. In assessing how best to meet that objective, the Board finds it helpful to view measurements of a liability as made up of three basic building blocks:
- (a) an estimate of the future cash flows (see paragraphs 34–62)
 - (b) the effect of the time value of money (see paragraphs 63–70)
 - (c) a margin (see paragraphs 71–89).
- 32 Measurement models differ in how they determine these building blocks. For example, cash flow estimates may be current or 'locked in', discounting may or may not be incorporated explicitly, an explicit or implicit margin may or may not be included, and different models set different objectives for any margin. Paragraphs 34–89 consider various approaches to each building block. Paragraphs 90–119 then draw together the Board's preliminary views on each building block into an overall preliminary view on the most useful approach to measurement.
- 33 In many existing accounting models, because the initial measurement of the liability equals the premium received (perhaps after deducting acquisition costs, as discussed in chapter 4), the insurer does not identify explicitly the three building blocks described in paragraph 31. Nevertheless, that initial measurement can be described as containing those three building blocks implicitly, as follows:
- (a) an estimate of the future cash flows, made at inception
 - (b) the effect of the time value of money, determined at inception
 - (c) an implicit margin, determined at inception. The margin is the difference between the premium paid by the policyholder at inception and the estimate of the future cash flows, discounted for the time value of money.*

* Acquisition costs are also relevant here. Chapter 4 discusses acquisition costs. The rest of chapter 3 ignores acquisition costs.

Estimates of future cash flows

Overall objective for estimates of cash flows

- 34 Paragraph 31 identifies three building blocks included in a measurement of an insurance liability. The first building block is an estimate of the future cash flows arising from the contract. The Board intends to give high level guidance on their estimation, but not to develop detailed guidance, such as might be found in an actuarial textbook. Appendix E is a working draft of such guidance. In summary, the Board's preliminary view is that an insurer should, in measuring insurance liabilities, make estimates of future cash flows that:
- (a) are explicit. (paragraph 35)
 - (b) are as consistent as possible with observable market prices. (paragraphs 36–38)
 - (c) incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations. (paragraphs 39–43)
 - (d) are current, in other words they correspond to conditions at the end of the reporting period. (paragraphs 44–55)
 - (e) exclude entity-specific cash flows. Cash flows are entity-specific if they would not arise for other entities holding an identical obligation. (paragraphs 56–62)

Explicit estimates

- 35 Some believe that estimates of cash flows should be explicit in all cases. Others argue that explicit estimates are not needed if the overall measurement of the insurance liability contains sufficient margins to make it reasonably unlikely that the actual cash flows will exceed that measurement. However, in the Board's preliminary view, explicit estimates result in a more faithful representation of the claims of policyholders on the resources of the insurer. The resulting information is more relevant to users, more understandable and more comparable with information produced by applying IFRSs to other liabilities, for example provisions (IAS 37) and employee benefits (IAS 19 *Employee Benefits*).

Consistency with observed market prices

- 36 Some inputs used to estimate cash flows relate to observable market variables, such as interest rates or prices of traded equities. Some argue that an insurer should substitute its own estimate of those variables if the insurer believes other evidence is more persuasive than the observed rates or prices. Some also argue that short-term fluctuations in market prices are of limited relevance for long-duration contracts that insurers generally do not (and cannot) transfer to a third party.
- 37 However, the Board's preliminary view is that measurements are more relevant and reliable if they are consistent with observed market prices, because such measurements:
- (a) involve less subjectivity than measurements that use the insurer's own estimates.
 - (b) reflect all evidence available to market participants.
 - (c) are developed using a common and publicly accessible benchmark that users can understand more easily than information developed using a private internal benchmark.
- 38 Therefore, the Board's preliminary view is that the inputs used to develop estimates of cash flows should, as far as possible, be consistent with observed market prices. This view has the following consequences:
- (a) An insurer would use observable current market variables, such as interest rates, as direct inputs without adjustment.
 - (b) For many insurance contracts, many significant estimates relate to variables (such as mortality or the frequency and severity of claims) that cannot, in general, be observed directly from transaction prices and other market prices. In developing these estimates, an insurer would need to consider all available data, external and internal. However, the estimates should not contradict current market variables. For example, estimated probabilities for inflation scenarios should not contradict probabilities implied by market interest rates.

Unbiased use of all available information

- 39 Because insurance contracts transfer risk, the cash flows generated by an insurance contract are uncertain. In other words, several outcomes are possible. Some argue that a measurement of an insurance liability should use a single estimate of the cash flows, for example the most likely

outcome or an outcome that is likely to prove ‘sufficient’ at some implicit or explicit level of confidence. However, a measurement of an insurance liability is most useful if it captures information about the full range of possible outcomes and their probabilities. Therefore, the Board’s preliminary view is that the measurement should start with an estimate of the **expected present value** of the cash flows generated by the contract. The expected present value is the probability-weighted average of the present value of the cash flows.

- 40 Determining an expected present value involves:
- (a) identifying each possible scenario
 - (b) determining the present value of the cash flows in that scenario. Paragraphs 69 and 70 discuss the discount rate.
 - (c) making an unbiased estimate of the probability of that scenario occurring. Depending on the circumstances, an insurer might develop these estimates by identifying individual scenarios, by developing a formula that reflects the insurer’s estimate of the shape and width of the probability distribution or by random simulation.
- 41 An expected present value is not a forecast that a particular outcome will occur. Therefore, differences between the ultimate outcome and the previous estimate of expected value are not ‘errors’ or ‘failures’. The expected value is a summary that incorporates all foreseeable outcomes: when one of those outcomes occurs, that outcome does not invalidate the previous estimate of the expected value.
- 42 Many insurance liabilities contain significant embedded options and guarantees. Most accounting models have, until recently, attributed no value to embedded options or guarantees that have no ‘intrinsic value’ because they are currently out of the money. However, such embedded options and guarantees also have a ‘time value’ because they could be in the money at expiry.^{*} Because the expected present value approach considers all possible outcomes, it incorporates both the intrinsic value and time value of embedded options and guarantees. Therefore, it represents their economic substance more faithfully.

* A note on terminology: The time value of an **option** refers to the part of an option’s value that arises because the option may be in the money at expiry. The time value of **money** refers to the fact that the value of a cash flow depends on the date of its receipt or payment.

- 43 In the Board’s preliminary view, estimates of the probabilities associated with each cash flow scenario should be neutral.^{*} In other words, they should not be biased with the intention of attaining a predetermined result or inducing particular behaviour. Neutrality is essential because biased financial reporting information cannot faithfully represent economic phenomena. Among other things, neutrality requires that estimates of cash flows and the associated probabilities should be neither conservative nor optimistic.

Current estimates

- 44 It seems to be widely accepted that estimates of cash flows for claims liabilities[†] should be based on all currently available information. However, there are two main approaches to estimating cash flows during the pre-claims period. One approach makes estimates at inception and uses the same estimates throughout the life of the contract, unless the insurer needs to recognise a loss because of a liability adequacy test.[§] In other words, that approach ‘locks in’ estimates made at inception and, except for the liability adequacy test, ignores information that becomes available later. Supporters of that model:
- (a) note that many existing accounting models use it.
 - (b) suggest that it is consistent with the customer consideration approach that the Board and the FASB are exploring in their joint project on revenue recognition (see paragraphs 113–115).
 - (c) argue that it is less burdensome and costly than the current estimate approach described in paragraph 45, involves fewer subjective estimates and portrays less volatility.

* Another note on terminology: Some approaches to risk margins use ‘risk-neutral’ probabilities incorporating adjustments to reflect the estimated risk aversion of market participants. For the analysis used in this paper, the unadjusted ‘real world’ probabilities need to be unbiased. The adjustments that convert the ‘real world’ probabilities into ‘risk-neutral’ probabilities are a form of risk margin. This paper treats risk margins as one building block and estimated cash flows (the cash flows in each scenario and the ‘real world’ probabilities) as a separate building block.

† Chapter 1 defines claims liabilities and pre-claims liabilities. This distinction is important for non-life insurance. For most life insurance, claims liabilities are generally a small proportion of the total because they are typically settled soon after they arise.

§ Paragraphs 54 and 55 discuss what a liability adequacy test is and how it might work.

- (d) argue that for some participating contracts, changes in estimates may be borne, in substance, by policyholders. For those contracts, many changes in estimates simply change the split between the fixed part of policyholder liabilities and the participating part of those liabilities. In those cases, requiring detailed estimates may cause unnecessary cost.
 - (e) observe that cost-based approaches are used to determine policyholder dividends for some contracts.
- 45 The other approach to the pre-claims period uses all currently available information in making estimates. For the following reasons, the Board favours that current estimate approach:
- (a) It gives a more faithful representation of the insurer's contractual obligations and rights, and conveys more useful information about the amounts, timing and uncertainty of the cash flows generated by those obligations and rights. Given the uncertainty associated with insurance liabilities and the long duration of many insurance contracts, current information about the amount, timing and uncertainty of cash flows is particularly relevant for users.
 - (b) It requires an insurer to consider actively whether circumstances have changed. In contrast, in a 'lock in' approach, an insurer may consider explicit estimates unnecessary if previous measurements contained significant implicit cushions. This creates a risk that an insurer may not identify changes in circumstances.
 - (c) It avoids the need for a separate liability adequacy test, because the measurement already incorporates all available information. Any liability adequacy test is likely to involve some elements that are arbitrary. For example, such a test implicitly recognises some favourable changes in estimates if they happen to occur at the same time as other changes that are adverse. Similarly, such a test does not reveal adverse changes if those changes are absorbed by large implicit margins that existed at inception.
 - (d) It provides a more coherent framework for more complex contracts, such as multi-year, multi-line or stop loss contracts. It may also reduce (and perhaps eliminate, depending on the approach to risk margins) the need to separate embedded derivatives. In addition, it may reduce the motivation for using reinsurance transactions, at a time selected by management, to recognise previously unrecognised economic gains.

- (e) It is consistent with other IFRSs for provisions (IAS 37) and financial liabilities (IAS 39). Both IAS 37 and IAS 39 require measurements based on current estimates of future cash flows.
 - (f) It reduces possible accounting mismatches between insurance liabilities and the insurer's assets, and should highlight economic mismatches more clearly. Chapter 5 discusses these mismatches.
- 46 Although the Board favours estimates based on all available information, this does not mean that estimates would be identical to the most recent actual experience. On the contrary, the most recent experience would supply only one of the possible outcomes that an insurer would need to consider. For example, suppose that mortality experience last year was 20 per cent worse than previous experience and previous expectations. Several factors could have caused that change, including lasting changes in mortality, changes in the characteristics of the insured population (eg changes in underwriting or distribution, or selective lapses by policyholders in unusually good or bad health), random fluctuations and identifiable non-recurring causes. In the Board's approach, an insurer would investigate why experience changed and would develop new probability estimates for each possible outcome, in the light of the most recent experience, earlier experience and other information. Typically, the expected present value of the cash flows would increase, but not by as much as 20 per cent. If mortality continues to run significantly above previous estimates, the estimated probability assigned to high-mortality scenarios will gradually increase over time. Actuaries have developed various 'credibility' techniques that an insurer could use in assessing how new evidence might affect the probabilities of different outcomes.
- 47 Insurers already use estimates of future cash flows for some aspects of many existing accounting models, such as for liability adequacy tests. In addition, many insurers already use cash flow estimates as one factor in pricing decisions. Nevertheless, a current estimate approach places more pressure on estimates of cash flows than most existing accounting models, particularly for longer duration contracts. This is because changes in estimated cash flows affect profit or loss immediately in a current estimate approach, but may do so only over time in some existing approaches. Moreover, if it is clear that no shortfall exists, an insurer is unlikely to estimate cash flows in detail for a liability adequacy test (see below for a discussion of such tests and shortfalls).

- 48 As the example in paragraph 46 indicates, expected present value has one other advantage: as an insurer accumulates small pieces of evidence supporting changes to the estimated probabilities, the expected present value is likely to change gradually. In contrast, many existing accounting approaches leave the estimates unchanged until the insurer has accumulated so much evidence that a significant change in estimates occurs. In other words, the expected present value approach should lead to more frequent, but smaller, changes in the carrying amount of insurance liabilities.
- 49 The range of reasonable estimates of the probability of each scenario is often wide. Therefore, it is important not only that estimates of the probabilities for each scenario should faithfully represent conditions at the reporting date, but also that changes in estimated probabilities should faithfully represent changes in conditions during the period. For example, suppose that estimates were at one end of a reasonable range at the beginning of the period. If conditions have not changed, moving estimates to the other end of the range at the end of the period would not faithfully represent what has happened during the period.
- 50 In updating its estimates of the probability for each scenario, an insurer would need to consider both the evidence that supported its previous estimates and all available new evidence, giving more weight to evidence that is more persuasive.
- 51 Some propose that an insurer should not change its estimates if the insurer views the change as unsustainable. However, this notion is redundant in an expected value approach: if the insurer views a change in experience as unsustainable, the insurer will assign low probabilities to those scenarios in which the change persists.
- 52 Some have suggested that estimates should be current for some variables, but locked in at inception for other variables. For example, some advocate:
- (a) current estimates for financial variables. Using current estimates for financial variables would avoid accounting mismatches that would arise if the assets backing the insurance contracts were measured on a basis, such as fair value, that uses current estimates for financial variables.
 - (b) locked-in estimates for non-financial variables (subject to a liability adequacy test). More specifically, the initial measurement of the liability would include an implicit profit margin, set at a level that avoids any profit at inception. Subsequently:

- (i) adverse changes in estimates of non-financial variables would be absorbed by the implicit profit margin. Once that margin is exhausted, any further adverse change is recognised in profit and loss.
 - (ii) favourable changes in estimates of non-financial variables would not be recognised.
- 53 For the following reasons, the Board does not favour the approach described in the previous paragraph:
- (a) Users will obtain more relevant information if current estimates are used for all variables.
 - (b) There may be interdependencies between financial variables (such as interest rates and equity prices) and non-financial variables (such as inflation rates, claim rates for some types of insurance or lapse rates). Also, some cash outflows (such as minimum guaranteed death benefits for some unit-linked life insurance contracts) may depend on both financial and non-financial variables. In such cases, arbitrary allocations may be needed to separate the effect of changes in financial variables from changes in non-financial variables.
 - (c) That approach uses the implicit profit margin to absorb adverse changes in non-financial variables. Paragraphs 73–75 explain why, in the Board’s preliminary view, it is not the function of the margin to act in this fashion as a ‘shock absorber’.

Liability adequacy test

- 54 If assets are not measured at a current value, they are generally subject to a test to determine whether their carrying amount needs to be reduced (an impairment test). Similarly, if a liability is not measured at a current value, a test is required to determine whether its carrying amount needs to be increased (a liability adequacy test). For convenience, this chapter describes any loss recognised as a result of a liability adequacy test as a **shortfall**. Because IFRS 4 permits many existing accounting approaches for insurance contracts to continue and many of those approaches do not use current values, IFRS 4 requires a liability adequacy test for insurance contracts.
- 55 Paragraph 44 describes a ‘lock in’ approach that estimates cash flows at inception and uses the same estimates throughout the life of the contract. That approach would need to incorporate a liability adequacy test: if the carrying amount of the liability is less than some specified

current value of the future cash flows estimated using all available information, the carrying amount would need to be increased. If a liability adequacy test is used, several details would need to be resolved, including the following:

- (a) What would be the level of aggregation? The rigour of the test depends heavily on the level of aggregation, which is unavoidably arbitrary. If the test is performed at a high level of aggregation, gains on some contracts would be implicitly offset against losses on other contracts, and shortfalls would be identified rarely.
- (b) Would the current value specified as a comparison include a risk margin and a service margin, such as the margins discussed later in this chapter? If so, how would they be determined?
- (c) How would such a test deal with embedded options and guarantees? Would it consider both their intrinsic value and their time value (optionality)? Would intrinsic value and time value be determined on a basis consistent with observable current market prices?
- (d) Given that any shortfall would be determined on a present value basis, would the insurer subsequently add interest to the loss? Similarly, if the shortfall includes a risk margin, service margin or both, would the insurer recognise income as it is released from risk or provides the services? How would the insurer present these items in the income statement?
- (e) Suppose that a liability adequacy test results in the recognition of a shortfall and circumstances change so that the shortfall no longer exists. Would the shortfall be reversed?

Entity-specific cash flows

- 56 A measurement of an insurance liability should represent faithfully the economic characteristics of that liability. Therefore, that measurement should reflect the cash flows generated by that liability. It should not capture cash flows generated by other assets and liabilities or arising from synergies between the insurance liability and other assets or liabilities. In other words, the measurement should not capture cash flows that are specific to the insurer and would not arise for other market participants holding an obligation that is identical in all respects (entity-specific cash flows).

- 57 Commentators sometimes misunderstand the proposition that the measurement of an insurance contract should exclude entity-specific cash flows. The cash flows necessarily depend on the characteristics of the specific liabilities being measured. For example, unbiased estimates of mortality rates depend on the demographics of the portfolio being measured and are, therefore, **portfolio**-specific. The fact that they are **portfolio**-specific does not make them **entity**-specific. Another insurer might have different underwriting standards, but the estimated mortality rates for an existing portfolio should reflect the characteristics of that portfolio, not the characteristics of the different portfolio that different underwriting standards would have generated.
- 58 In principle, consistency with observed market prices implies that estimates of cash flows should be consistent with the estimates that other market participants would make. Nevertheless, many variables cannot be observed in, or derived directly from, market prices (eg the frequency and severity of insurance claims and mortality). For such variables, there is rarely, if ever, persuasive evidence that the insurer's own estimates differ from the estimates that other market participants would make. For these variables, the distinction between entity-specific estimates and market estimates has little practical significance.
- 59 The above paragraphs distinguish entity-specific cash flows from cash flows that would arise for other market participants. That distinction is most likely to be significant for the costs of servicing insurance contracts during their life. Some argue that the measurement of an insurance liability should reflect the servicing costs that the insurer expects to incur. They argue that this will give users more relevant and reliable information than information based on hypothetical cash flows that would occur only in the unlikely event that the insurer transfers the liability to another party.
- 60 However, using estimates of the entity's own servicing costs would incorporate cash flows that relate not to the liability itself but to synergies with other recognised or unrecognised assets or liabilities. Therefore, the Board's preliminary view is that the measurement of the liability should be based on the servicing costs that market participants would incur.
- 61 The estimates of servicing costs would need to reflect the characteristics of the contracts being measured, including the level of service provided to policyholders and the approach to claims management. Those characteristics affect the future cash flows that market participants would consider. For example, aggressive, but expensive, claims

management will lead to low claims but high expenses. Similarly, the level and type of service might affect the degree of adverse selection. That would occur if the level and type of service affect lapse rates more for some classes of policyholders than for others.

- 62 If an insurer observes that other insurers incur higher or lower servicing costs than it does, the insurer would need to assess whether the difference arises from differences in the characteristics of the contracts or differences in efficiency. In practice, the Board expects that an insurer would use estimates of its own servicing costs, unless there is clear evidence that the insurer is significantly more or less efficient than other market participants.

Time value of money

- 63 The second building block used in measuring an insurance liability relates to the time value of money. This paper discusses two questions under this heading:
- (a) Should the carrying amount of insurance liabilities reflect the time value of money? (see paragraphs 64–68)
 - (b) If the carrying amount of insurance liabilities reflects the time value of money, how should the discount rate be determined? (see paragraphs 69 and 70)

Should the carrying amount of insurance liabilities reflect the time value of money?

- 64 Life insurance liabilities are generally measured on a basis that reflects the time value of money (ie they are discounted). However, in most countries other than Australia, Canada and New Zealand, most non-life claims liabilities are not discounted. In other countries, discounting is sometimes used for a limited range of non-life claims liabilities that meet criteria that vary by country, such as duration (eg more than four years), payment type (eg annuity payments) and the precision with which the timing of payments can be estimated.
- 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.

Materiality

- 67 Some suggest that discounting should be prohibited, or at least not required, for insurance liabilities and insurance assets that will lead to cash flows within one year. They argue that:
- (a) the effect of discounting is not likely to be material in these cases.
 - (b) a one-year cut-off is practical and cost-effective, because it does not require preparers to estimate the effect of discounting before deciding whether discounting is needed.
- 68 However, in the Board's preliminary view, discounting is appropriate for all insurance liabilities, including all non-life claims liabilities. There should be no specific exemption for cash flows within one year, because discounting could sometimes have a material effect for these items. 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.

Determining the discount rate

- 69 Some existing accounting approaches for insurance liabilities use a discount rate based on the expected returns on the actual assets held. However, the Board does not regard this as appropriate: the objective of the discount rate is to adjust estimated future cash flows for the time value of money in a way that captures the characteristics of the liability, not the characteristics of the assets viewed as backing those liabilities. Therefore, the discount rate should be consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability, in terms of, for example, timing, currency and liquidity. It should exclude any factors that influence the observed rate but are not relevant to the liability (for example, risks not present in the liability but present in the instrument for which the market prices are observed). The Board does not intend to develop detailed guidance on how to achieve that objective.
- 70 This paper treats the time value of money and margins as two separate building blocks of the measurement. Some existing accounting models combine these two building blocks by using risk-adjusted discount rates. That is not appropriate unless risk is directly proportional to the amount of the liability and the remaining time to maturity. Insurance liabilities often do not have these characteristics. For example, the average risk in a portfolio of claims liabilities may rise over time because more complex claims may take longer to resolve. Similarly, lapse risk may affect cash

inflows more than it affects cash outflows. Moreover, risk margins generally reduce the value of future cash inflows but increase the value of future cash outflows. A single risk-adjusted discount rate is unlikely to capture these differences in risk.

Margins

- 71 The third building block used in measuring an insurance liability is a margin. Paragraphs 72–86 discuss margins for the service of bearing risk (risk margins) and paragraphs 87–89 discuss margins for other services (service margins).

Risk margins

- 72 If financial reporting is to represent faithfully the difference between a liability with fixed cash flows and a liability with uncertain cash flows, the measurement of liabilities needs to include an input that reflects the extent of uncertainty. This paper describes that input as a risk margin. The following paragraphs discuss:
- (a) the purpose of a risk margin (paragraphs 73–75)
 - (b) estimating the risk margin (paragraphs 76 and 77)
 - (c) calibrating the risk margin per unit (paragraphs 78–82)
 - (d) profit at inception (paragraphs 83–85)
 - (e) the Board’s preliminary view on the risk margin (paragraph 86).

Purpose of a risk margin

- 73 Some view risk margins as a ‘shock absorber’—something included in the liability to avoid recognising an expense in the future if payments to policyholders exceed the amount previously recognised as a liability. Others view risk margins as an explicit and unbiased measurement of the compensation that entities demand for bearing risk. In other words, at each reporting date an insurer would assess how much risk remains in

the liabilities and would adjust the risk margin accordingly. Table 3.1 compares the first view (shock absorber view) and second view (compensation view). Example 1 in appendix G illustrates these views numerically.

Table 3.1 Risk margin – two views		
<i>Purpose of the margin</i>	<i>Shock absorber</i>	<i>Compensation</i>
Does the risk margin reduce as the insurer is released from risk?	Yes	Yes
Do adverse changes in estimates of cash flows affect profit when they occur?	No (until the margin is exhausted) ^(a)	Yes
Do favourable changes in estimates of cash flows affect profit when the change occurs?	No ^(b)	Yes
Does the risk margin at the end of the period reflect:		
• increases in the amount of risk?	No	Yes
• decreases in the amount of risk (ie release from risk)?	Yes	Yes
• the amount of risk remaining at the end of the period?	No ^(c)	Yes
• the price of risk at the end of the period?	No	It depends (see table 3.2)
Do increases in the amount of risk, or increases in the price of risk, cause the insurer to recognise additional expense at that time, followed by income in a later period?	No	Yes
<p>(a) Until the risk margin is exhausted, adverse changes in estimates increase the expected present value of the liability, but this is absorbed by the risk margin. Thus, the total liability is unchanged, and the adverse change reduces future profit, not current profit.</p> <p>(b) Arguably, favourable changes in estimates may affect profit if they reverse previous adverse changes.</p> <p>(c) Unless the quantity of risk has not increased since inception.</p>		

- 74 Supporters of the shock absorber view argue that it has the following advantages:
- (a) It leads to less volatility in profit or loss and equity than the compensation view does.
 - (b) Under the compensation view, if the insurer concludes in a subsequent period that the amount of risk, or the price of risk, has increased, the insurer recognises additional margins and expense at that time, and then inevitably recognises income in a later period when the insurer is released from that additional risk. That income does not represent cash received or receivable from the policyholder, but instead represents cash that might have been receivable if the insurer had been free to reprice the contract. Users are not accustomed to this approach and may find it counter-intuitive.
 - (c) Although both views require the insurer to estimate the **quantity** of risk that remains at each reporting date, the shock absorber view does not require insurers to make subjective estimates of the **price** of risk after inception.
 - (d) Some regard the shock absorber view as particularly relevant for participating contracts because participating policyholders bear risks up to a specified point. Beyond that point, the risks are borne by shareholders (if any).
 - (e) The shock absorber view may be more compatible with the customer consideration approach that the Board and the FASB are considering as one possible approach for their joint project on revenue (see paragraphs 113–115).
- 75 The Board’s preliminary view is that risk margins are compensation for bearing risk. The Board regards this approach as preferable because it:
- (a) reports changes in estimates promptly and transparently.
 - (b) reports identical exposures as identical and reports exposures that differ as different. In contrast, the shock absorber view would mean that an insurer might, if the entire risk margin has been used up to absorb losses, measure a highly uncertain liability at the same amount as a fixed liability.
 - (c) results in a risk margin that has a clear objective. In contrast, the remaining risk margin reported under the shock absorber view can be described only as the result of a computation.

- (d) requires entities to focus more explicitly on their risk exposures. This is likely to lead to an improved understanding of risk, and more reliable reporting.

Estimating the risk margin

- 76 The risk margin cannot typically be observed, so the insurer would do the following to estimate it, both at inception and subsequently:
- (a) assess how market participants would measure the quantity of risk, and determine the units that they would use to express the quantity of risk. Appendix F refers to some units that some have proposed as suitable for at least some circumstances (such as the amount of required capital* or a percentile of the estimated probability distribution).
 - (b) use the cash flow scenarios to estimate the number of units of risk present in the liability.
 - (c) estimate the margin per unit of risk using an appropriate combination of observed market prices for similar contracts, pricing models, and other inputs, if available. Inputs might include prices for similar new contracts, reinsurance prices, prices for catastrophe bonds or other insurance-linked securities and information on prices for business combinations or portfolio transfers. Those inputs would need adjustment if they relate to items whose characteristics differ from those of the contracts being measured.
 - (d) multiply the estimated margin per unit by the estimated number of units to determine the aggregate margin. The change in the aggregate risk margin is income or expense.
 - (e) test for possible errors and omissions by reconciling the change in the risk margin to changes in the number of units of risk and the margin per unit. Typically, the number of units of risk reduces over time because the insurer is released from risk. However, in some cases, the estimated number of units of risk may increase (for example, if some unforeseen source of uncertainty emerges or if embedded options come into the money).
- 77 The scenarios and probability distributions used in estimating the expected present value of cash flows would provide some evidence about

* If the unit of risk is based on the amount of required capital, it is also necessary to consider the period for which the insurer must hold that capital.

the number of units of risk, but not about the margin per unit of risk. For example, suppose an insurer concludes in a particular case that market participants would require a margin equal to 3 times the estimated standard deviation of the cash flows.* Suppose also that the estimated probability distribution results in a standard deviation of CU50.† Then, the aggregate risk margin is CU150 (standard deviation of CU50 times the margin per unit of 3).

Calibrating the risk margin per unit

- 78 In general, the price for an insurance liability is observable only once: at inception, when the insurer and policyholder agree a mutually acceptable price for the contract. That price is one source of evidence that an insurer could use at inception in calibrating the risk margin per unit of risk. The Board considered two ways to use that evidence in implementing its preliminary views. Because they are variants of the same underlying approach rather than different approaches, the following discussion labels them simply as implementations A and B. Both implementations estimate the cash flows in the same way, use the same discount rates and require a risk margin and, if applicable, a service margin. However, they place different weights on the premium as evidence of the risk margin per unit at inception.
- (a) Implementation A calibrates the margin per unit at inception directly to the actual premium charged (less relevant acquisition costs, as discussed in chapter 4), unless a liability adequacy test reveals a loss at inception. One consequence is that an insurer would not recognise a profit at inception.
 - (b) Implementation B treats the observed price for the transaction with the policyholder as an important reasonableness check on the initial measurement of the insurance liability, but does not use it to override an unbiased estimate of the margin that market participants require. If there is no evidence that the insurer's pricing differs from the pricing that other market participants require, implementations A and B lead to the same result at inception.
 - (c) A possible intermediate implementation would include a rebuttable presumption that market participants require a margin

* In using this example, the Board does not wish to imply that standard deviation is necessarily an appropriate measure of the quantity of risk.

† CU = currency units

consistent with the margin implied by the actual premium (less relevant acquisition costs).

79 The following table compares the two implementations. Example 2 in appendix G, which is highly simplified, illustrates them numerically.

Table 3.2 Risk margin - calibration		
	<i>Implementation A</i>	<i>Implementation B</i>
Is the margin calibrated to the premium (less relevant acquisition costs)?	Yes	No, but the premium serves as a reasonableness check
Is there a need to define relevant acquisition costs?	Yes	No, except for the reasonableness test
Is a liability adequacy test needed at inception?	Yes	No
Is a liability adequacy test needed subsequently?	No	No
Is a profit recognised at inception (if market participants would charge a lower premium)?	No	Yes
Does the insurer recognise income as the number of units of risk reduces (a release from risk)?	Yes	Yes
Does the insurer recognise an expense if the number of units of risk increases?	Yes	Yes
Does the insurer need to estimate the price that market participants require per unit of risk:		
• at inception?	Yes (for the liability adequacy test)	Yes
• subsequently?	No	Yes
<i>continued...</i>		

<i>...continued</i>		
During the term of the contract, does the margin reflect changes in the estimated price that market participants require per unit of risk?	No	Yes
If applicable, does the insurer recognise income as it provides services other than bearing risk?	Yes	Yes

80 Some comments on table 3.2 follow:

- (a) Implementation A calibrates the margin directly to the premium less relevant acquisition costs, so it must define relevant acquisition costs. Implementation B does not need to define acquisition costs because they play no direct role in calibrating the margin (although they may play an indirect role in the reasonableness test described above).
- (b) In some cases, an insurer expects a contract to be unprofitable (or, perhaps, insufficiently profitable) because of, for example, the state of the insurance cycle,^{*} government or regulatory restrictions on price changes, or underpricing to buy or maintain market share. In those cases, the premium would not represent faithfully the insurer's obligation. To identify such cases, implementation A requires a liability adequacy test at inception. Subsequently, implementation A requires no liability adequacy test because this implementation 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. Implementation B requires no liability adequacy test, either at inception or subsequently, because all the building blocks use current information.
- (c) Using implementation A, at inception an insurer never recognises a profit after acquisition costs. At a gross level, income is recognised at inception, equal to the relevant acquisition costs. In implementation B, the actual premium provides a reasonableness check. If the estimated margin differs significantly from the margin implied by the actual premium (less relevant acquisition costs), further investigation may be needed, to identify omissions and errors. Nevertheless, if the insurer concludes, after

^{*} Some insurance pricing displays a cycle of alternating 'hard' markets, when pricing is high, and 'soft' markets, when pricing is low.

further investigation, that the estimated market price for bearing risk (and, if applicable, providing other services) differs from the price implied by the premiums that it charges, the insurer would recognise a profit at inception.

- (d) In both implementations, an insurer recognises a loss at inception if the contract provides a margin that is below the margin required by market participants.
- (e) In both implementations, an insurer needs to identify the number of units of risk at the beginning and end of the period, and the reduction during the period in the number of units of risk (the release from risk).
- (f) Implementation A differs from the shock absorber view discussed in paragraphs 73–75. Neither implementation recognises a profit at inception. However, they differ in their treatment of subsequent changes in cash flow estimates. Applying the shock absorber view, the risk margin absorbs unfavourable changes. The shock absorber view also ignores favourable changes and does not measure the remaining risk. In contrast, implementation A recognises subsequent changes in estimate, both favourable and unfavourable, and it measures the remaining quantity of risk.

Calibration: arguments for implementation A

81 Proponents of implementation A argue as follows:

- (a) The transaction with the policyholder provides the only observable direct market benchmark for the margin. There is no reliable and non-arbitrary way to determine the margin on any other basis. For a margin determined on another basis, it is not possible to establish whether a profit recognised at inception is genuine, rather than the result of a measurement error. Moreover, the required margins cannot be 'back-tested'. In other words, the actual cash flows from a book of contracts can never validate the earlier estimate of the margin. This is because the margins reflect both the quantity of risk and the price per unit of risk. Actual outcomes over some years might give some level of confidence that the quantity of risk has been estimated reliably, but later events can never show whether the price per unit of risk was appropriate.
- (b) Insurers are contractually required to provide a service (ie bearing risk) throughout the contract term. The policyholder derives utility from the subsequent provision of the service, but derives no

separate utility from the inception of the contract. Therefore, an insurer should recognise no profit until it begins to be released from risk.

- (c) Implementation A is consistent with IAS 39. IAS 39 prohibits the recognition of gains at inception if they are not evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or not based on a valuation technique whose variables include only data from observable markets.* Assembling a portfolio could be viewed as a form of ‘repackaging’. Also, measurements of insurance contracts would always rely on some data that are not from observable markets.
- (d) Recognition of a profit at inception is imprudent, especially if based on inherently subjective estimates. Information about the value added by new contracts is useful supplementary disclosure, especially for long-term contracts, and complements the measurements in the financial statements, but is unsuitable for inclusion in those measurements.
- (e) Because estimates of margins would be subjective, the Board may feel compelled to issue prescriptive guidance on this topic for implementation B. Detailed guidance could contradict the principle of estimating what market participants would require.
- (f) Recognising a profit at the inception of non-life contracts may make it more difficult for users to interpret traditional ratios, such as the claims ratio and combined ratios described in paragraph 111.

Calibration: arguments for implementation B

82 Arguments for implementation B are as follows:

- (a) An IFRS on insurance contracts should not restrict the recognition of profits at inception if all assets and liabilities relating to the contract are recognised and measured appropriately. Prohibiting the recognition of profits at inception would lead to the inclusion in liabilities of deferred profits that do not represent obligations. The result would not be a faithful representation of the insurer’s financial position.

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

- (b) An insurer sometimes charges different premiums for identical obligations, for example because it wishes to balance its portfolio by encouraging some risk profiles and discouraging others. If so, implementation A portrays the obligations as different but implementation B portrays them as the same.
- (c) If an insurer added value by issuing a contract, the financial statements should report that added value. That added value could be regarded as an implicit fee for assembling a portfolio (paragraph 84 discusses this notion). Reporting that added value as income could respond to the wish of some users for information about the level of new business, and its estimated profitability. Disclosures about new business often interest users of the embedded value information that some life insurers produce.
- (d) Although subsequent losses, lapses or other events could reverse profits that were appropriately recognised at inception, it is more transparent to report those events when they occur, rather than to obscure them by offsetting them against profits that were deferred at inception.
- (e) Some insurance markets are subject to an insurance cycle. In other words, premium rates may fluctuate significantly from period to period, leading to high profitability in a 'hard market' and low profitability (or even losses) in a 'soft market'. Implementation A would require insurers to recognise losses at inception when the market is soft without recognising profits at inception when the market is hard. This is inconsistent.
- (f) Implementation A needs a liability adequacy test at inception. For this test, an insurer would need to estimate the margin that market participants would require. A rough estimate might suffice if the actual premium is clearly adequate. However, the need to carry out this test would create an additional burden and would reduce the benefit of attempting to calibrate to the price observed for the transaction with the policyholder.
- (g) Implementation A is likely to need some guidance not needed for implementation B:
 - (i) a definition of the unit of account for the liability adequacy test. This affects the frequency and size of losses identified, because aggregation implicitly offsets losses on some contracts against gains on others.

- (ii) a definition of relevant acquisition costs for the initial calibration of the margin.
- (iii) criteria to distinguish amendments to an existing contract from the cancellation of an old contract that is replaced by a new contract.

Profit at inception

- 83 Implementation A prohibits the recognition of a profit at the inception of an insurance contract, but implementation B does not. Such a profit could arise from:
- (a) an ability to sustain higher pricing than other market participants might require (eg in a niche market or if the insurer has superior distribution systems).
 - (b) an element captured in pricing but not reflected in accounting measurements (eg if pricing implicitly passes on to policyholders expected future investment margins but accounting measurements exclude those margins), or vice versa.
 - (c) accidental or deliberate use of over-optimistic or otherwise flawed estimates.
 - (d) an element included in pricing but not relating to the insurer's remaining obligation. The following paragraph explores this notion.
- 84 Insurers aim to set premiums that cover various items, such as:
- (a) items that relate to the insurer's remaining contractual obligations and are relevant to their measurement:
 - (i) the expected present value of the cash flows arising from the contract.
 - (ii) an adequate margin for the risks undertaken and, if applicable, services provided.
 - (b) other items, that do not relate to the remaining obligations and are not relevant to their measurement:
 - (i) acquisition costs (see chapter 4). If the acquisition costs and the related portion of the premium are both recognised at inception, they do not cause a profit.

- (ii) explicit or implicit fees for separate services, if any, provided to the policyholder at inception. Implementations A and B both recognise the cost of providing these services and the related revenue when the service is provided.
- (iii) compensation for the effort of assembling a portfolio of contracts (an implicit portfolio assembly fee). Implementation A would not recognise the implicit portfolio assembly fee as revenue at inception. Instead, it would include it in the total margin and would recognise revenue pro rata to the release from risk. In contrast, implementation B recognises the implicit portfolio assembly fee as income at inception, because assembly of the portfolio has already occurred and the implicit portfolio assembly fee does not relate to the insurer's remaining contractual obligation. Example 3 in appendix G illustrates possible treatments of a portfolio assembly fee.

85 Some have expressed a concern that implementation B would, at the inception of a contract, cause an insurer to recognise immediately the entire profit expected over the life of the contract. However, that is not the case for any approach that has ever been discussed by the Board, the Insurance Working Group or the former IASC Steering Committee. Even if an insurer recognises some profit at inception, it would recognise the following items as income or expense in later periods:

- (a) compensation for bearing risk during the period (ie the difference between the opening and closing risk margins) and, if applicable, compensation for providing services during the period (ie the difference between the opening and closing service margins).
- (b) investment margin (ie return on assets held, less interest accumulated on the insurance liability).
- (c) experience adjustments (ie differences between the actual cash flows and their previous expected value) and changes in estimates.

Preliminary view on the risk margin

86 The Board has reached the following preliminary views on the risk margin:

- (a) The objective of a risk margin is to convey decision-useful information to users about the uncertainty associated with future cash flows. The objective is not to provide a shock absorber for the unexpected, nor is it to enhance the insurer's solvency.

- (b) To best meet that objective, the risk margin should be an explicit and unbiased estimate of the margin that market participants require for bearing risk.
- (c) The Board does not intend to prescribe specific techniques for developing risk margins. Instead, the Board intends to explain the attributes of techniques that will enable risk margins to convey useful information to users about the uncertainty associated with risk margins. Appendix F contains a draft discussion of those attributes.
- (d) Several Board members support implementation A, for reasons given in paragraph 81. They believe the margin should be calibrated to the observed price for the transaction with the policyholder and, in consequence, that an insurer should not recognise a profit at inception. However, a majority of Board members support implementation B, for reasons given in paragraph 82. They believe the observed price for the transaction with the policyholder, although useful as a reasonableness check on the initial measurement of the insurance liability, should not override an unbiased estimate of the margin another party would require to take over the insurer’s contractual rights and obligations.

Service margins

- 87 The discussion above concentrates on margins for bearing risk (risk margins). However, many insurance contracts require an insurer to provide other services as well. An important example is when the contract requires the insurer to provide investment management services, such as in many unit-linked contracts or universal life contracts and some participating contracts. An investment manager would not take on an obligation to provide investment management services without adequate compensation. Similarly, presumably an insurer would not willingly provide the same services within an insurance contract without adequate compensation.
- 88 This suggests that the measurement of an insurance liability should include a service margin if market participants typically require such a margin. The inclusion of a service margin has the following implications, as illustrated in examples 4 and 5 in appendix G:
- (a) If the contract provides an explicit or implicit service margin in line with the margin that market participants typically require, the insurer recognises a liability equal at inception to the initial

premium received less acquisition costs. If the acquisition costs exceed the initial premium, the insurer recognises an asset (provided that the insurer can recover that asset from future premiums that either (i) pass the guaranteed insurability test described in chapter 4 or (ii) are enforceable).

- (b) If the contract provides an explicit or implicit service margin lower (higher) than required by market participants, the liability recognised is higher (lower) than in (a) and the insurer recognises a loss (profit) at inception. Similarly, when an asset is recognised, that asset is lower (higher) than in (a).
- (c) If the acquisition costs incurred are higher (lower) than the acquisition costs that market participants typically incur, this reduces (increases) the available service margin. This affects the liability or asset recognised at inception in (a) and (b). Chapter 4 discusses acquisition costs.
- (d) If the insurer concludes that part of the initial premium relates to services provided at inception or to an implicit portfolio assembly fee (see paragraph 84), the insurer recognises this part of the premium as revenue at inception.
- (e) As the insurer subsequently renders the related service, the service margin reduces and the insurer recognises the reduction as revenue. The revenue recognised in the period is the margin that market participants would require for rendering services in that period, not the margin that is implicit or explicit in the contract.
- (f) If it becomes apparent during the life of a contract that market participants would require a higher service margin than previously estimated, the measurement of the liability increases accordingly.
- (g) The approach to the service margin differs in three respects from the treatment of revenue under IAS 18:
 - (i) At inception, IAS 18 would not result in a profit. It would result in a loss at inception only if the contract is onerous.
 - (ii) Applying IAS 18 subsequently, the revenue recognised is the margin that was implicit or explicit in the contract, not the service margin that market participants require.
 - (iii) Applying IAS 18 subsequently, the measurement of the liability does not change if it becomes apparent that market participants would require a higher service margin.

- (h) The inclusion of an explicit service margin is an important difference between the approach favoured by the Board and embedded value approaches. Paragraphs 105–110 discuss embedded value.
- 89 The Board’s preliminary view is that the measurement of an insurance liability should incorporate, in addition to the margin for the service of bearing risk (risk margin), an unbiased estimate of the margin, if any, that market participants would require for rendering other services (service margin).

Summary of the Board’s preliminary view on the three building blocks

- 90 The Board’s preliminary view is that an insurer should measure all its insurance liabilities using the following three building blocks:
- (a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows.
 - (b) current market discount rates that adjust the estimated future cash flows for the time value of money.
 - (c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).
- 91 In the Board’s view, a measurement using those three building blocks provides several benefits to users of an insurer’s financial statements:
- (a) relevant information about the amount, timing and uncertainty of future cash flows arising from existing insurance contracts. Given the uncertainty associated with insurance liabilities and the long duration of many insurance contracts, such information is particularly important.
 - (b) a requirement for insurers to make explicit estimates of cash flows and margins, rather than rely on the implicit margins that existed at inception. Explicit estimates are likely to require insurers to gain a deeper understanding of the risks, lead to more robust estimates of cash flows and reduce the risk that insurers will overlook changes in circumstances.
 - (c) a consistent approach to changes in estimates. In most existing approaches, the liability adequacy test implicitly recognises some favourable changes by offsetting them against adverse changes.

Thus, these existing approaches recognise favourable changes arbitrarily, depending on whether adverse changes occur at the same time and on the size of implicit margins that existed at inception.

- (d) an appropriate and consistent approach for all types of insurance (and reinsurance) contracts, that also provides a coherent framework to deal with more complex contracts (such as multi-year, multi-line or stop loss contracts) and to resolve emerging issues without resorting to arbitrary new rules and distinctions.
- (e) consistency with other IFRSs that require current estimates of future cash flows in measuring provisions (see IAS 37) and financial liabilities (see IAS 39).
- (f) no need to separate embedded derivatives (especially in implementation B) because the measurement includes a market-consistent estimate of both their intrinsic value and their time value. If features of the embedded derivatives and of the host contract are interdependent, separating them may be arbitrary and costly.
- (g) no need for anti-abuse rules to prevent selective recognition of previously unrecognised economic gains through reinsurance, or for arbitrary criteria to distinguish amendments to an existing contract from new contracts.
- (h) clearer reporting of economic mismatches between insurance liabilities and related assets, and a reduction in accounting mismatches. Chapter 5 discusses economic mismatches and accounting mismatches.
- (i) consistency with observable current market prices, to the extent they are available. Such prices provide a more understandable and credible benchmark for users, even though market prices are not available to support all inputs used in measuring insurance liabilities.

Identifying the measurement attribute

- 92 How do the three building blocks fit together? The measurement that results from using those three building blocks will be most helpful to users if it represents faithfully a real-world economic attribute of the asset or liability being measured. Assets and liabilities have various attributes, such as cost, depreciated cost, amortised cost or various forms of current value, such as fair value. The attribute used in the financial statements is sometimes described as the measurement attribute.
- 93 In the Board's preliminary view, a measurement using the three building blocks represents faithfully an attribute of an insurance liability, and an informative and concise name for that measurement attribute is 'current exit value'. Current exit value can be defined as the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. Typically, the current exit value of an insurance liability is not observable, so it must be estimated using the three building blocks described above.
- 94 A measurement of insurance liabilities at current exit value is not intended to imply that an insurer can, will or should transfer the liability to a third party. Indeed, in most cases, insurers cannot transfer the liabilities to a third party and would not wish to do so. Rather, the purpose of specifying this measurement attribute is to provide useful information that will help users make economic decisions.
- 95 The Board has considered several other possible measurement attributes, discussed below:
- (a) current entry value (paragraphs 96–101)
 - (b) value in settlement with the policyholder (paragraphs 102 and 103)
 - (c) fair value (paragraph 104)
 - (d) embedded value (paragraphs 105–110)
 - (e) unearned premium (paragraphs 111 and 112)
 - (f) allocated customer consideration (paragraphs 113–115).

Current entry value

- 96 Some believe that current exit value places too much emphasis on hypothetical transactions that rarely happen. Instead, they advocate measurements based on transactions that do occur. Specifically, they suggest that an insurer should measure its insurance liabilities at a current value that reflects prices charged to policyholders, rather than the price for a hypothetical transfer of the liability to another entity. Some describe the resulting measurement attribute as current entry value, as opposed to current exit value.
- 97 The Board explored two versions of current entry value. The first version was defined as the amount that the insurer would charge a policyholder today for entering into a contract with the same remaining rights and obligations as the existing contract. For the following reasons, the Board concluded that this version would not be fruitful:
- (a) Although a price may be available at inception, it is not generally available later in the contract because an insurer would not typically sell new contracts with the same remaining exposure. Thus, if a price is estimated for a date after inception, that price is likely to be a theoretical construct. It would require the same types of estimates as those required for current exit value. The following are reasons why new contracts are not available at a later date:
 - (i) By that stage, the portfolio of risks is only a subset of the original risks and the insurer may not be willing to insure such a concentrated portfolio.
 - (ii) Prospective policyholders wishing to buy coverage at a late stage are more likely to be drawn disproportionately from higher-risk groups. This would lead an insurer to charge a higher premium to protect itself against adverse selection.
 - (b) This version reflects items such as changes in estimates and changes in discount rates only if the insurer's own pricing methodology reflects them. If considerable reliance is placed on an insurer's own pricing system to derive measurements, comparability may be lost.
 - (c) The current price for new contracts may be skewed by the insurer's desire to encourage some risk profiles, and discourage others, to balance its portfolio. The price for those marginal new contracts may not be representative for equivalent contracts in the portfolio as a whole.

- 98 The second version of current entry value explored by the Board is the amount a rational insurer would charge a policyholder today for entering into a contract with the same remaining rights and obligations. This version places less emphasis on the insurer's own pricing methodology and instead refers to pricing by a rational insurer. It uses current estimates of cash flows and a current discount rate, with the margin calibrated at inception to the actual premium. However, this description is close to the definition of current exit value, differing only in how the margin is determined. Thus, the Board regards this second version not as current entry value but as one possible implementation of current exit value (described above as implementation A). Describing this second version as current entry value would over-emphasise a distinction (between entry and exit) that may not be significant in many cases.
- 99 The Board considered whether there could be a systematic difference between the margin that would be likely in the (entry, primary or retail) market between the insurer and the policyholder and the margin that would be likely in the (exit, secondary or wholesale) market between the insurer and a hypothetical transferee. However, if insurers were collecting margins that significantly exceed those that would be likely in wholesale markets, presumably other insurers would lower their premiums to gain market share. Therefore, it seems unlikely that significant differences of this type could occur systematically for long periods. Thus, the Board's preliminary view is that the margin would be unlikely to be affected to any great extent by whether the measurement attribute is an entry value or an exit value.
- 100 Reinsurers sometimes charge lower premiums than those charged by the direct insurer for the same exposure. The Board considered whether this fact might indicate significant differences between entry values and exit values. There are two plausible reasons for such differences:
- (a) The reinsurer may be diversifying the exposure more broadly. This is a unit of account issue and does not affect the selection of the measurement attribute.
 - (b) If a reinsurer faces less onerous regulation (eg lower capital requirements), it may be able to satisfy the obligation at lower cost than the direct insurer does. In this case, presumably a potential transferee would maximise the use of reinsurance if this is the most cost-effective way to service the liability. It follows that the price for a hypothetical transfer of the liability to another insurer may be presumed to incorporate the benefit of cost advantages that the transferee could access through reinsurance. Furthermore, if

the market with the policyholder is competitive, presumably competition will lead insurers to pass on to policyholders at least some of the benefits of cost advantages available through reinsurance. Thus, it should not matter whether the hypothetical transaction that determines the current exit value is defined in terms of the market with policyholders or the market with reinsurers or other transferees.

- 101 Some suggest that a measurement based on individual contracts is an entry value and a portfolio measurement is an exit value. However, the distinction between an individual measurement and a portfolio measurement relates to the unit of account, not to the measurement attribute. Chapter 5 discusses the unit of account.

Value in settlement with the policyholder

- 102 Some argue that current exit value is irrelevant if, as is usually the case, an insurer does not intend to (and typically cannot) transfer the liability to another party. They suggest that it would be more appropriate to measure the liability on a basis that reflects the insurer's intention to discharge its obligation by making contractually required payments to or for policyholders.
- 103 However, in determining an acceptable price to take on an insurance liability, a transferee would necessarily consider the cash flows that would arise under the contract. Therefore, in estimating current exit value, an insurer would estimate the cash flows that would arise for a hypothetical transferee, including the ultimate cash flows to the policyholder. The insurer would make similar estimates of the cash flows if it retained the obligation (so long as entity-specific cash flows are excluded, for the reasons given in paragraphs 56–62).

Fair value

- 104 The Board published in November 2006 a discussion paper *Fair Value Measurements* (FVM). The objective of that project is to define fair value more clearly and provide guidance on measuring fair value when another standard requires its use. That project is not intended to increase the use of fair value in IFRSs. Appendix C includes further information on the FVM project. Because the Board has not yet reached final conclusions on the definition of fair value (in the FVM project) or current exit value (in the project on insurance contracts), the Board is not yet in position to determine whether these two notions are the same. However, the Board has not identified significant differences between them.

Embedded value

- 105 The Board has considered whether embedded value would be an appropriate measurement attribute for an insurer's rights and obligations under insurance contracts. Example 6 in appendix G provides a generic illustration of the use of embedded value. European Embedded Value Principles, published by the CFO Forum (of about 20 major European insurers), define embedded value as follows:

Embedded value (EV) is the *present value* of shareholders' interests in the earnings distributable from assets allocated to the *covered business* after sufficient allowance for the aggregate risks in the *covered business*.

The EV consists of the following components:

- *free surplus* allocated to the *covered business*
- *required capital*, less the cost of holding *required capital*
- *present value* of future shareholder cash flows from in-force covered business (PVIF).

The value of future new business is excluded from the EV.

[Italics identify other terms defined in the European Embedded Value Principles. To avoid unnecessary detail, this paper does not include those definitions.]

- 106 Some life insurers report embedded value information, generally as supplementary information (often unaudited) outside the financial statements. A few, mainly British and Irish financial conglomerates, use embedded value measurements in their primary financial statements. The reporting of embedded value information is most prevalent in Australia, Canada, New Zealand, South Africa, the UK and, increasingly, Continental Europe. Some life insurers in other countries use embedded value information internally but do not publish it. Non-life insurers do not typically report embedded value information because it would convey little additional information for short-duration contracts.
- 107 Some assert that analysts of life insurers concentrate on embedded value information if it is available. For example, some commentators on ED 5 *Insurance Contracts* stated that embedded value methodology is far more relevant and reliable than most local accounting models, and insurers should be permitted to adopt it. They noted that embedded values are often an important consideration in determining prices for acquisitions of insurers and of blocks of insurance contracts. Furthermore, embedded

value and similar indirect methods are often used in accounting for the insurance liabilities assumed in these acquisitions.

108 The following criticisms have been made of existing implementations of embedded value:

- (a) Embedded value approaches have been largely unregulated. As a result, there has been diversity in their application. To reduce this diversity, in 2004 the CFO Forum issued European Embedded Value Principles.* Members of the CFO Forum now apply those principles.
- (b) In the past, embedded values have generally been determined on a single best estimate basis that does not reflect the full range of possible outcomes. This basis does not generally address adequately embedded guarantees and options, such as embedded interest rate guarantees. More attention is now being devoted to these options and guarantees and some embedded value methods are beginning to address both their intrinsic value and their time value.
- (c) Embedded value reflects risk through a 'risk discount rate' used to discount the future cash flows. The methods used to determine this rate are viewed by some as fairly crude, diverse and not always fully consistent with capital market prices.
- (d) Embedded value attempts to reflect the economic cost of capital locked in by capital requirements. Some believe that this is one way of determining part of the risk margins that market participants require. However, there is diversity in the way these cost of capital requirements are developed and applied.
- (e) Embedded value has appeared to reward investment in riskier assets by, for example, reporting CU100 of equities as worth more than CU100 of bonds. However, that is not a necessary component of embedded value, and there appears to be a trend towards a 'market-consistent embedded value' (MCEV) that is intended to be consistent with prices observed in the capital markets.
- (f) Embedded value typically includes contractual rights to implicit or explicit future service fees at an amount that does not explicitly include the service margin, if any, that market participants require. This may be one of the main reasons why new business often results in significant increases in embedded value at inception ('new business gains') and may remain ultimately as the most important difference between current exit value and MCEV.

* <http://cfoforum.nl/eev.html>

- (g) Embedded value is an indirect method of measuring insurance liabilities. Indirect methods measure the liability by discounting all cash flows arising from both the book of insurance contracts and the assets supporting the book, to arrive at a net measurement for the contracts and supporting assets. The measurement of the assets is then deducted to arrive at a measurement of the book of contracts. Direct methods measure the liability by discounting future cash flows arising from the book of insurance contracts only. In principle, direct and indirect methods can produce the same results if the same assumptions are made in both methods.* However, some question whether this theoretical equivalence is achievable in practice.
- 109 The CFO Forum argues that embedded value may provide useful supplementary information about long-duration contracts, but suggests that it is not an appropriate measurement attribute for the financial statements because it reflects longer-term value creation and is not a suitable basis for distribution decisions.
- 110 The Board's preliminary view is that current exit value is a more relevant measurement attribute than embedded value, especially versions of embedded value that are not market-consistent.

Unearned premium

- 111 Some suggest that insurers should be permitted or required to measure short-duration non-life insurance pre-claims liabilities using an unearned premium approach. This approach would measure the liability initially at the net premium (the premium received less relevant acquisition costs). Subsequently, the insurer would measure the pre-claims liability at the unearned portion of that net premium. Proponents of this approach give the following arguments:
- (a) For many short-duration contracts, the pre-claims period is short (six months on average for an annual contract). If an insurer identifies significant changes in that short period, the changes are much more likely to lead to losses than to gains. If any material losses exist, a liability adequacy test would detect them. For these contracts, unearned premium may be a reasonable proxy for current exit value, but obtainable with less cost and effort.

* Luke N. Girard, *Market Value of Insurance Liabilities: Reconciling the Actuarial Appraisal and Option Pricing Methods*, North American Actuarial Journal, Volume 4, Number 1

- (b) Users are accustomed to using information about earned premiums and incurred claims to derive important ratios, such as claims ratios* and combined ratios.† A prospective measurement (ie one based on future cash flows) may imply that insurers should report premiums as deposits (not revenue) and claims as returns of deposits (not expenses). Chapter 7 discusses these presentation issues.
 - (c) Most existing accounting models use an unearned premium approach for non-life pre-claims liabilities.
 - (d) An unearned premium approach is more consistent with the customer consideration approach that the Board and the FASB are considering as one possible approach in their project on revenue recognition (see paragraphs 113-115).
- 112 The Board's preliminary view is that current exit value is the most relevant and reliable measurement attribute for all insurance contracts. For many short-duration contracts, unearned premium may often be a reasonable approximation to current exit value. However, an insurer should not make this assumption without testing it, particularly if a contract is likely to be highly profitable or highly unprofitable, or circumstances have changed significantly since inception.

Allocated customer consideration

- 113 In their joint project on revenue recognition, the IASB and FASB are exploring two models for revenue recognition. In the fair value model, the performance obligations are initially measured at fair value. In the customer consideration model, they are initially measured by allocating the amount of consideration received from the customer. The boards intend to publish in 2007 a discussion paper that explains, illustrates and compares these models.
- 114 The boards have not yet discussed some aspects of the customer consideration model, for example:
- (a) Is there a liability adequacy test at inception and subsequently? If so, how does it work? For instance, are risk margins included?
 - (b) Is interest accrued on the performance obligation?

* The claims ratio is incurred claims divided by earned premiums.

† The combined ratio is (incurred claims plus expenses) divided by earned premiums.

- (c) How is the customer consideration attributed to individual periods for contracts with complex features (eg stop loss, deductibles and guarantees for which the risk fluctuates both up and down over time)?
- 115 Because insurance contracts transfer risk to the insurer, often for long periods, these aspects are critical to finding a relevant and reliable measurement model for insurance liabilities. Therefore, the customer consideration model is 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 for risk and, if applicable, other services.

Summary of preliminary views in this chapter

- 116 The Board's preliminary view is that an insurer should measure insurance liabilities using the following three building blocks:
- (a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows.
 - (b) current market discount rates that adjust the estimated future cash flows for the time value of money.
 - (c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).
- 117 Several Board members believe that the margins described in the previous paragraph should be calibrated to the observed price for the transaction with the policyholder. In consequence, an insurer would never recognise a profit at inception. However, a majority of Board members believe that the observed price for the transaction with the policyholder, although important as a reasonableness check on the initial measurement of the insurance liability, should not override an unbiased estimate of the margin another party would require if it took over the insurer's contractual rights and obligations.
- 118 In the Board's preliminary view, an informative and concise name for a measurement using the three building blocks described above is 'current exit value'. Current exit value could be defined as the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. Current exit value is typically not observable. Therefore, it must be estimated using the three building blocks discussed in this chapter.

- 119 A measurement at current exit value is not intended to imply that an insurer can, will or should transfer the liability to a third party. Rather, the purpose of specifying this measurement attribute is to provide useful and cost-effective information that will help users to make economic decisions.

Questions for respondents

Question 2

Should an insurer measure all its insurance liabilities using the following three building blocks:

- (a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows,
- (b) current market discount rates that adjust the estimated future cash flows for the time value of money, and
- (c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin)?

If not, what approach do you propose, and why?

Question 3

Is the draft guidance on cash flows (appendix E) and risk margins (appendix F) at the right level of detail? Should any of that guidance be modified, deleted or extended? Why or why not?

Question 4

What role should the actual premium charged by the insurer play in the calibration of margins, and why? Please say which of the following alternatives you support.

- (a) The insurer should calibrate the margin directly to the actual premium (less relevant acquisition costs), subject to a liability adequacy test. As a result, an insurer should never recognise a profit at the inception of an insurance contract.
- (b) There should be a rebuttable presumption that the margin implied by the actual premium (less relevant acquisition costs) is consistent with the margin that market participants require. If you prefer this approach, what evidence should be needed to rebut the presumption?

- (c) The premium (less relevant acquisition costs) may provide evidence of the margin that market participants would require, but has no higher status than other possible evidence. In most cases, insurance contracts are expected to provide a margin consistent with the requirements of market participants. Therefore, if a significant profit or loss appears to arise at inception, further investigation is needed. Nevertheless, if the insurer concludes, after further investigation, that the estimated market price for risk and service differs from the price implied by the premiums that it charges, the insurer would recognise a profit or loss at inception.
- (d) Other (please specify).

Question 5

This paper proposes that the measurement attribute for insurance liabilities should be the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. The paper labels that measurement attribute 'current exit value'.

- (a) Is that measurement attribute appropriate for insurance liabilities. Why or why not? If not, which measurement attribute do you favour, and why?
- (b) Is 'current exit value' the best label for that measurement attribute? Why or why not?

Chapter 4 Policyholder behaviour, customer relationships and acquisition costs

- 120 One of the building blocks discussed in chapter 3 is the estimated cash flows. For many insurance contracts, cash flows depend on whether policyholders exercise contractual options. Often, an insurer expects that some policyholders will exercise their options in a way that benefits the insurer. This chapter:
- (a) discusses whether an insurer should recognise expectations of such benefits (paragraphs 121–160). If an insurer does recognise them, the measurement model discussed in chapter 3 would apply to them.
 - (b) discusses whether such expectations are relevant to the treatment of (i) acquisition costs (paragraphs 161–166) and (ii) intangible assets associated with insurance contracts acquired in a business combination or portfolio transfer (paragraphs 167–172).
 - (c) summarises the Board’s preliminary views on issues discussed in this chapter (paragraphs 173 and 174)

Beneficial policyholder behaviour

Background

- 121 Many insurance contracts permit, but do not require, the policyholder to continue paying premiums in order to receive continued insurance coverage. If policyholders continue to pay premiums, the insurer will receive economic benefits (the premiums) and will transfer economic benefits (the resulting insurance coverage) to the policyholders. In many cases, an insurer expects a net economic loss if one class of policyholders continues paying premiums and net economic benefits if another class of policyholders does so.
- 122 An insurer expects a net economic loss if the expected premium inflows are less than the resulting expected benefit payments to the same class of policyholders.* The insurer has a contractual obligation to stand ready to provide the insurance coverage if it receives the premiums. Therefore, estimated cash flows used in measuring the insurance liability should

* More precisely, a net economic loss arises if the risk-adjusted expected present value of the premiums is less than the risk-adjusted expected present value of the resulting benefit payments to the same class of policyholders.

include the premiums from that class of policyholders and the resulting additional policyholder benefits. That conclusion is not likely to be contentious.

- 123 Conversely, an insurer expects net economic benefits if the expected future premiums exceed the resulting expected benefit payments to the same class of policyholders. The following discussion considers whether the insurer should recognise those net economic benefits.
- 124 Existing IFRSs provide several relevant precedents:
- (a) An option does not oblige the holder to exercise it. Therefore, an option cannot be a liability of the holder or an asset of the option-writer.
 - (b) The fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date when payment could be required (see IAS 39).
 - (c) Internally generated customer relationships do not qualify for recognition as assets (see IAS 38 *Intangible Assets*).
 - (d) Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. The asset represents the entity's contractual right to benefit from providing investment management services, and is amortised as the entity recognises the related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis (see the appendix to IAS 18 *Revenue*).
 - (e) IFRS 4 permits an insurer to retain most aspects of its previous accounting models for insurance contracts. Even when an insurer cannot compel the policyholder to pay future premiums, many existing accounting models include future premiums either directly in the measurement of the insurance liability or indirectly in assessing the recoverability of deferred acquisition costs.
- 125 Questions about beneficial policyholder behaviour could arise:
- (a) if an insurer expects net economic benefits from one class of policyholders and net economic losses from another class. Paragraphs 129–160 discuss this issue.
 - (b) if a measurement model leads to the recognition of a profit:

- (i) at the inception of an insurance contract. Chapter 3 discusses this issue.
 - (ii) in subsequent periods. The discussion in paragraphs 129–160 is relevant to this issue.
 - (c) if an insurer has priced insurance contracts to recover acquisition costs. Paragraphs 161–166 discuss acquisition costs.
- 126 For simplicity, the discussion concentrates on contractual options that permit policyholders to choose whether they cancel or continue their contracts (continuation and cancellation options). Similar considerations apply for other options held by policyholders, including options to convert one type of contract into another, to add additional contract elements ('riders'), to pay an additional premium to reinstate coverage for the remainder of the original contract term after an insured event, or to keep a contract in force without paying further premiums, in exchange for reduced benefit payments (eg making the contract 'paid up').
- 127 In this paper:
- (a) **beneficial policyholder behaviour** refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer.
 - (b) **unfavourable policyholder behaviour** refers to a policyholder's exercise of a contractual option in a way that generates a net economic loss for the insurer.
- 128 The following are examples of cases when an insurer might expect policyholder behaviour to be beneficial for one class of policyholders and the same policyholder behaviour to be unfavourable for another class:
- (a) The probability of an insured loss is higher for one class but, for legal or other reasons, the insurer cannot charge a differential premium reflecting the different probabilities of loss. For the low-probability class, future premiums may exceed the resulting claims. For the high-probability class, the resulting claims may exceed the premiums.
 - (b) The insurer charges differential premiums at inception, but expects that some policyholders will migrate to another class over time. If the contract does not permit the insurer to change the premium after inception, expected claims for those policyholders may exceed the related premiums.

An introductory example

- 129 The following highly simplified example illustrates a case in which an insurer expects net economic benefits from one class of policyholders and net economic losses from another class. In this example, that difference arises when policyholders migrate from one class to another. A brief summary of the example follows. For those readers who would like to follow the numbers through in detail, Example 7 in appendix G gives more details of the fact pattern and underlying computations.
- 130 An insurer issues 10,000 two-year term life insurance contracts on 1 January X1 as follows:
- (a) The contracts are priced to break even if the actual cash flows equal the insurer's estimate of the expected value of the cash flows.
 - (b) On 1 January X1, all policyholders are healthy. The insurer estimates at inception that 10 per cent of policyholders will become unhealthy at the end of X1. Unhealthy policyholders will suffer higher mortality in X2 than healthy policyholders. At the end of X1, the insurer does not know which policyholders have become unhealthy and the contract does not permit the insurer to change the premium after inception.
 - (c) Estimated lapse rates at the end of X1 are 10 per cent for healthy policyholders and 1 per cent for unhealthy policyholders. The insurer expects net economic losses if unhealthy policyholders continue paying premiums and net economic benefits if healthy policyholders do so.
 - (d) For simplicity, the example ignores the time value of money. It also assumes that the insurer requires no risk margin or service margin, and incurs no acquisition costs or servicing costs. A more complete example would include these features, but they do not affect the discussion below.
- 131 Table 4.1 shows the insurer's balance sheet at the end of X1 applying each of four approaches to future premiums and policyholder benefits. Paragraph 132 explains the four approaches. The table uses labels to identify which cash flows are incorporated in the measurements of assets and liabilities. Those labels are not intended to show how financial statements would label the assets and liabilities recognised in each approach, nor are they intended to indicate whether each approach would recognise a single asset or liability or recognise separate assets and liabilities.

Table 4.1 Beneficial policyholder behaviour				
<i>Balance sheet end of X1</i>	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>
	<i>exclude all future premiums</i>	<i>unhealthy only (with lapse of unhealthy)</i>	<i>unhealthy only (no lapse of unhealthy)</i>	<i>healthy and unhealthy</i>
	<i>CU000</i>	<i>CU000</i>	<i>CU000</i>	<i>CU000</i>
Cash	758	758	758	758
Net future cash inflows from healthy	–	–	–	581
Net future cash outflows to unhealthy	–	(1,339)	(1,353)	(1,339)
Equity	<u>758</u>	<u>(581)</u>	<u>(595)</u>	<u>–</u>

132 The four approaches are as follows:

- Approach A excludes all future premiums, and death benefit payments that result from those premiums. In other words, it excludes all policyholder behaviour, both beneficial and unfavourable. The insurer recognises the cash received in X1 (CU758) and no other asset or liability. The insurer recognises a profit of CU758 in X1 and a loss of CU758 in X2. The insurer has a contractual obligation to accept premiums on 1 January X2 and expects that obligation to result in net cash outflows. Therefore, the Board views approach A as untenable and this paper does not discuss it further. As discussed below, all three of the other approaches include unfavourable policyholder behaviour, but they differ in their treatment of beneficial policyholder behaviour.
- Approach B includes unfavourable policyholder behaviour relating to existing contracts and excludes beneficial policyholder behaviour. The insurer recognises a liability of CU1,339 for expected future net cash outflows to unhealthy policyholders (outflows of CU1,880 and inflows of CU541). The measurement excludes expected future net cash inflows from healthy policyholders. The insurer reports negative equity of CU581 at 31 December X1, even though it expects the contract to break even. The insurer recognises a loss of CU581 in X1 and a profit of CU581 in X2.

- Approach C excludes policyholder behaviour that results in net cash inflows. Unlike approach B, it also excludes policyholder behaviour that reduces net cash outflows. In this example, surrenders by unhealthy policyholders reduce net cash outflows. The insurer includes premiums from all 950 unhealthy policyholders, even though the insurer expects that only 940 of them will pay the premium due on 1 January X2. In consequence, the insurer also includes death benefit payments for 190 unhealthy policyholders, even though the insurer expects to pay only 188 death benefits (because of the expected 10 lapses). Under approach C, the insurer recognises a liability of CU1,353, rather than the CU1,339 recognised under approach B. The difference of CU14 comprises expected additional death benefit payments totalling CU20 to two unhealthy policyholders, less expected additional receipts totalling CU6 from 10 unhealthy policyholders.
- Approach D includes all policyholder behaviour, both beneficial and unfavourable, relating to existing contracts. The insurer recognises the cash of CU758 received in X1 and a net liability of CU758 for all policyholders. This example does not consider whether the insurer should present a single net liability of CU758 or break it down into one or more assets and one or more liabilities. The net liability comprises net cash outflows of CU1,339 to unhealthy policyholders as a group (as in approach B) less net cash inflows of CU581 from healthy policyholders as a group (inflows of CU4,431 and outflows of CU3,850). The resulting equity of zero is consistent with the break-even pricing for zero gain and zero loss. As noted above, this example excludes the time value of money and risk margins.

133 Paragraphs 134–136 provide an overall summary of the arguments for applying each of approaches B, C and D to this example. Paragraphs 137–160 then provide a more generic discussion and explain the Board’s preliminary views. Paragraphs 173 and 174 summarise those preliminary views.

Arguments for approach B (exclude policyholder behaviour that results in net cash inflows)

134 Approach B includes expected net cash outflows to unhealthy policyholders, but excludes those expected net cash inflows that will arise if healthy policyholders continue to pay premiums. Proponents of approach B offer the following arguments:

- (a) The insurer cannot compel healthy policyholders to pay premiums on 1 January X2. The insurer has written an option, permitting the policyholder to continue paying premiums. An option gives the holder the right, but not the obligation, to exercise the option. If the holder has no obligation, the writer of the option has no asset.
- (b) If the measurement includes cash flows arising from estimates of beneficial policyholder behaviour, some boundary is needed to determine which cash flows qualify for inclusion. As discussed in paragraphs 150–160, the only plausible boundary relies on the insurer’s contractual obligations. It is paradoxical for an insurer to recognise an asset (or a smaller liability) when it takes on an extra obligation.
- (c) Including expected benefits from policyholder behaviour would be inconsistent with the deposit floor in IAS 39. The deposit floor is an informal name for the specification that the fair value of a financial liability with a demand feature is not less than the amount payable on demand (discounted from the first date when payment could be required). In example 7 the contracts have no surrender value. Therefore, the amount payable on demand is zero.
- (d) The insurer’s expectation of receiving benefits from beneficial policyholder behaviour derives from a customer relationship, not from contractual rights. The objective of this project is to account for contractual obligations and contractual rights, not for customer relationships. An insurer may well have a valuable customer relationship, but that relationship is internally generated. Internally generated customer relationships do not qualify for recognition as an asset under IAS 38.

Arguments for approach C (exclude policyholder behaviour that results in net cash inflows or that reduces net cash outflows)

- 135 Approach C includes all cash flows that policyholders can require the insurer to make. Like approach B, it excludes net cash inflows from continuation by healthy policyholders. Unlike approach B, it excludes reductions in net cash outflows arising from surrenders by unhealthy policyholders. This approach is founded on the view that the insurer should not account for expected surrenders by unhealthy policyholders until they occur, because the insurer cannot compel unhealthy

policyholders to surrender. Some argue that approach C uses the principle underlying approach B and applies it more rigorously. Opponents note that approach C means the insurer would recognise expenses that it expects not to incur.

Arguments for approach D (include all policyholder behaviour relating to existing contracts)

- 136 Approach D includes all policyholder behaviour, both beneficial and unfavourable, relating to existing contracts. In this example, approach D includes all expected contractual cash flows from both healthy and unhealthy policyholders. Proponents of approach D offer the following arguments:
- (a) Approach D gives users more complete information about the amount, timing and uncertainty of cash flows resulting from the contracts, and more timely information about favourable and unfavourable changes in surrender behaviour.
 - (b) Approaches B and C are inconsistent with the pricing of the contracts. The pricing relies on expected net cash inflows from one class of policyholders (policyholders who remain healthy) to subsidise expected net cash outflows to another class (policyholders who become unhealthy). Thus, approaches B and C could systematically recognise large losses at the inception of contracts that are reasonably expected to be profitable. That would not be a faithful representation of the transaction.
 - (c) Approaches B and C treat regular premium contracts as short-term contracts containing an option for the policyholder to continue paying premiums if the expected present value of future premiums is less than the expected present value of the resulting additional policyholder benefits. However, this line of thinking contradicts the decision to buy insurance in the first place, because at inception the expected present value of premiums always exceeds the expected present value of policyholder benefits, unless the contract is underpriced. If circumstances do not change, the policyholder is likely to keep paying premiums. Buying a long-term contract and then cancelling it is not a cost-effective way to buy short-term coverage. Thus, it is more intuitive to view these contracts as long-term contracts containing a cancellation option that may become useful if the policyholder's circumstances change. Approach D is more consistent with that view.

- (d) If the insurer transferred all its contractual rights and contractual obligations to another party, the price would reflect realistic expectations of surrenders, not the immediate surrender value. Although some view the price as a combined price for two items (the contractual rights and obligations and a customer relationship), some proponents of view D regard this split as artificial because they believe that market participants would never transfer one component without the other.
 - (e) Although the policyholder has no contractual obligation to pay further premiums, the insurer has an intangible asset, namely the customer relationship. It is widely accepted that a customer relationship has value, even though customers have no corresponding obligation. A customer relationship meets the definition of an asset, and is accordingly recognised as an asset if acquired separately or in a business combination. Customer relationships do not qualify for recognition if generated internally (see IAS 38). However, in this case, part of the customer relationship (the part relating to expected policyholder exercise of existing contractual options) is so closely associated with the existing contract that recognition is justified.
 - (f) Excluding beneficial policyholder behaviour from the measurement leads to considerable complexity. The insurer would need to estimate at each reporting date how many contracts will generate net economic benefits and how many will generate net economic losses. Paragraphs 143–149 comment further on that point.
 - (g) Policyholders are often subject to tax penalties (or lose tax advantages) if they surrender some types of insurance contract (or long-term savings contract) before a specified period elapses. These penalties may strongly discourage surrender, even if the issuer cannot prevent surrender.
- 137 Building on the above discussion of approaches B–D in the context of example 7, the following issues are discussed below:
- (a) What is the nature of an insurer’s ability to derive economic benefits from beneficial policyholder behaviour (paragraphs 138–140)?
 - (b) If those benefits arise from a customer relationship, should the insurer recognise that part of the customer relationship as an asset (paragraphs 141 and 142)?

- (c) If an insurer recognises that part of a customer relationship as an asset, should the insurer present it as a separate asset or as a deduction in measuring the related insurance liability (paragraphs 143–149)?
- (d) What test must beneficial policyholder behaviour satisfy if measurement is to include it? Put differently, what defines the boundary between existing contracts and possible future contracts (paragraphs 150–160)?

Nature of expected benefits from beneficial policyholder behaviour

- 138 The insurer can derive benefits from the exercise by policyholders of rights that they hold under an existing contract (beneficial policyholder behaviour relating to an existing contract). Do those benefits arise from an existing contract or from an existing customer relationship? That distinction is important because:
- (a) customer relationships are intangible assets within the scope of IAS 38. Under IAS 38, internally generated customer relationships do not qualify for recognition as an asset.
 - (b) if the benefits arise from an existing contract, it may be appropriate to include them in one overall net measurement of the insurer's contractual rights and obligations. Conversely, it is normally more informative to present a customer relationship separately from the contractual rights and contractual obligations (see paragraphs 143–149 for further discussion).
- 139 Some argue that expected benefits from policyholder behaviour relating to existing contracts arise from the insurer's contractual rights and obligations, not from a customer relationship. They offer the following arguments:
- (a) The existing contract identifies the potential cash flows. Those cash flows are only a subset of all cash flows expected from existing customer relationships (which also include cash flows from repeat sales and from cross-selling). The relationship between insurer and policyholder may affect the probability of lapse, but the primary determinants of the cash flows are the contract itself and the policyholder's needs and preferences, not the broader customer relationship.
 - (b) Both the insurer and the policyholder view a regular premium contract as a long-term contract containing a cancellation option

that may become useful if the policyholder's circumstances change. They do not view it as a short-term contract containing an obligation for the insurer to stand ready to accept the remaining premiums if the policyholder chooses to pay them.

- (c) If the insurer transferred all its contractual rights and contractual obligations to another party, the price would reflect realistic expectations of policyholder behaviour. Splitting that price into two components (contractual rights and obligations and a customer relationship) would be artificial because market participants would never contemplate a transfer of one item without the other.
- 140 The policyholder has no contractual obligation to pay further premiums. Therefore, the Board's preliminary view is that the insurer's ability to derive benefits from policyholder behaviour arises from part of a customer relationship, not from the contract. This applies even if the policyholder behaviour relates to the exercise of options within an existing contract.

Should an insurer recognise a customer relationship as an asset?

- 141 The Board has concluded elsewhere that a customer relationship meets the definition of an asset. Thus, a customer relationship is recognised as an asset if acquired separately or in a business combination.
- 142 Customer relationships do not qualify for recognition as an asset if generated internally (see IAS 38). Therefore, some argue that an insurer should not recognise as an asset any part of an internally generated customer relationship. However, an existing insurance contract is closely associated with the part of the customer relationship that relates to expected policyholder exercise of existing contractual options. In the Board's preliminary view, this close association justifies the recognition of that part of the customer relationship (if appropriate conditions are met, as discussed later in this chapter). The Board does not intend to extend that conclusion to options in contracts other than insurance contracts.

Presenting the recognised part of the customer relationship

- 143 Should the insurer present the recognised part of the customer relationship as a separate asset, or combine it with the related insurance liability? The Board considered both conceptual and practical factors. Conceptually, a customer relationship with a policyholder does not

reduce or eliminate a contractual obligation to the same policyholder or another policyholder. In example 7, the insurer expects to benefit from contractually specified net cash inflows from healthy policyholders, but those rights do not reduce the insurer's contractual obligations towards unhealthy policyholders. Moreover, normal offsetting criteria are not met. Thus, there is no conceptual justification for presenting the right to benefit from some existing contracts as a reduction of the contractual obligations arising from the same or other contracts.

- 144 Nevertheless, there are practical reasons why the costs of distinguishing the customer relationship from the liability might exceed the benefits of making that distinction. The rights and obligations arise from individual contracts. Therefore, the insurer would need to distinguish between (a) classes of policyholders that will result in additional net economic benefits if the policyholders continue paying premiums and (b) classes that will result in net economic losses. That may seem easy for the highly simplified illustration in example 7, but it would be more difficult for a realistic example. The insurer would need to consider all contractual options held by the policyholder including immediate surrender, surrender at various alternative future dates, making the contract 'paid up' immediately (ie ceasing future payments but keeping the contract in force), making the contract paid up at various alternative future dates, holding the contract until maturity or exercising conversion or other options. Individual contracts might generate a net benefit (a customer relationship asset) at some times and a net obligation at other times. Some contracts might generate at the same time both a liability and a customer relationship asset.
- 145 To distinguish customer relationships from insurance liabilities, an insurer would also need to consider the probability that policyholders have migrated from one risk class to another (such as the policyholders who become unhealthy in example 7). The insurer would also need to consider the probability of future migrations. This would be difficult because generally the insurer has little or no access to information about changes in policyholders' risk characteristics.
- 146 To some extent, when the insurer estimates future cash flows, it must consider whether there are different classes of policyholders. However, more detailed analysis is required if it needs to distinguish beneficial policyholder behaviour from unfavourable policyholder behaviour. To make this distinction in example 7, the insurer must estimate how many policyholders are healthy and how many are unhealthy and it must estimate the lapse and mortality rates separately for these two classes. Its historical data will indicate that contracts lapsed or policyholders

died, but will not show policyholders' health status immediately before those events. In contrast, if the distinction is not made, the insurer needs to estimate in example 7 only one overall lapse rate (9.1 per cent) and one mortality rate (6.4 per cent).

- 147 In the Board's preliminary view, the cost of distinguishing the recognised part of the customer relationship from the insurance liability would exceed the benefits of doing so. Therefore, an insurer should treat the recognised part of the customer relationship as a reduction in the related insurance liability for recognition, measurement and presentation. The customer relationship would be measured in the same way as the related insurance liability (at current exit value). Thus, the amount recognised as an insurance liability would be the same as if the expected cash flows from beneficial policyholder behaviour arose from the contract itself, rather than from a customer relationship. The insurer would not be required to measure the customer relationship separately.
- 148 Users would benefit from information about the extent to which measurements depend on cash flows that are not enforceable. However, for reasons given above, it may not be feasible to require a quantified split of the measurement into enforceable and non-enforceable components. The Board plans to investigate disclosure alternatives before developing an exposure draft. Such alternatives might include sensitivity analysis of lapse risk, qualitative disclosure or disclosure of surrender values.
- 149 Applying the Board's preliminary views, an insurer need not separate the recognised part of the customer relationship from the related insurance liability. Nevertheless, the risk margins would need to reflect the risk associated with each set of cash flows. For example, different risks may be associated with (a) policyholder benefits that do not depend on future premiums, (b) future premiums and (c) policyholder benefits that depend on future premiums.

Boundaries of the existing contract

- 150 The preliminary views presented so far argue that an insurer should recognise expected benefits from policyholders' future exercise of rights they hold under an existing contract. What criteria should determine where an existing contract ends and where a possible new contract begins?
- 151 Some have suggested that a portfolio view automatically justifies the inclusion of beneficial policyholder behaviour. However, the contractual rights and obligations arise from individual contracts and do not change their character by being aggregated into a portfolio. Therefore, the

existence of a portfolio does not determine whether an asset exists (although it might make the measurements more precise). Nevertheless, even though contractual rights and obligations arise from individual contracts, that need not preclude a portfolio measurement if the rights and obligations arising from each contract within the portfolio qualify for recognition as an asset or liability. Chapter 5 discusses whether measurement should be performed on a portfolio basis.

- 152 In the view of some, the correct approach is to include all the cash flows that result from the contract, taking into account estimates of policyholder behaviour. However, in the Board's preliminary view, that approach would need to specify that cash flows are included only if they result from substantive features of the contract. Mere words on a piece of paper cannot be enough. For example, consider a one-year household insurance contract. Measurement of this contract based on estimates of future cash flows would consider only those cash flows that arise from this year's contract, and would ignore cash flows that may arise if the insurer and policyholder agree next year to renew the contract. Suppose the insurer changes the standard form of its contracts so that they become lifetime contracts, from which both the policyholder and the insurer are free to withdraw on any anniversary of the original contract date. Because this apparent contractual change creates no new substantive rights or obligations, it should not change the accounting.
- 153 It follows that some criterion is needed to ensure that policyholder behaviour is included only if it relates to contractual terms that create substantive rights or obligations. IFRSs refer in various places to notions such as substance, commercial substance, economic substance and economic reality. Therefore, the Board considered whether the criterion for including beneficial policyholder behaviour should be that it stems from contractual terms that have commercial substance (ie have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows from the contract). That criterion builds on generic notions that already exist in other IFRSs and does not treat insurance contracts as a special case.
- 154 Nevertheless, the Board concluded that introducing this notion could have significant consequences for other contracts, such as financial instruments, long-term supply contracts and leases. In addition, the Board noted that insurance contracts typically permit the policyholder to benefit from coverage for a period at a price that is contractually constrained. Accordingly, the Board's preliminary view is that future

premiums (and resulting additional benefit payments to policyholders) should be included in the recognised part of the customer relationship (and hence in the overall measurement of the insurance liability) if, and only if, any of the following criteria is met:

- (a) the policyholder must pay the premiums to retain guaranteed insurability (a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained).
- (b) the insurer can compel the policyholder to pay the premiums.
- (c) including the premiums and the resulting policyholder benefits will increase the measurement of the liability.

- 155 Criteria (b) and (c) are not controversial. They do not involve a customer relationship. Moreover, they are consistent with criteria that already apply to other types of contracts, such as financial instruments. Criterion (b) relates to those uncommon cases in which future premiums are contractually enforceable. Criterion (c) relates to cases in which the insurer has a stand-ready obligation (eg the unhealthy policyholders in example 7). However, criterion (a) (guaranteed insurability) would be unique to insurance contracts.
- 156 As noted above, IAS 39 includes a deposit floor. In other words, IAS 39 specifies that the fair value of a financial liability with a demand feature is not less than the amount payable on demand (discounted from the first date when payment could be required). In general, the Board's preliminary views would not result in a deposit floor for insurance liabilities. However, it follows from the preliminary views that the current exit value of an insurance liability (as reduced by the recognised part of the customer relationship) cannot be negative (ie an asset), unless that asset is recoverable from future premiums that meet one of the criteria specified in paragraph 154. The current exit value includes the risk-adjusted expected present value of future premiums that meet one or more of those criteria.
- 157 The criterion of guaranteed insurability excludes some future cash flows, such as expected future premiums during the accumulation phase of an annuity if the contract does not transfer significant insurance risk during

that phase.* Similarly, for universal life contracts,[†] the Board's preliminary view would include premiums, and the resulting additional policyholder benefits, if any of the criteria in paragraph 154 is met, and exclude all other premiums, such as those required to retain rights to other guarantees (eg guarantees of minimum crediting rates).

- 158 For many annual non-life insurance contracts, the policyholder has no guaranteed insurability beyond the end of the annual term. Thus, although the insurer may benefit from possible renewals, those renewals derive from a customer relationship that may lead to future contracts and would not affect the measurement of the insurance liability. Furthermore, that customer relationship does not qualify for recognition as an asset under IAS 38 (unless it was acquired separately or in a business combination).
- 159 Applying the Board's preliminary views, the measurement of regular premium insurance contracts would include future premiums that the insurer cannot compel the policyholder to pay. That is not a new proposal. Many existing accounting models include such premiums either directly in the measurement of the insurance liability or indirectly in assessing the recoverability of deferred acquisition costs.
- 160 Some have suggested that the main motivation for including future premiums in the measurement of regular premium insurance contracts is to avoid recognising significant losses at inception if acquisition costs are not deferred. However, as example 7 shows, the treatment of future premiums may be a significant issue even if an insurer incurs no acquisition costs and recognises no profits until the end of a contract. Paragraphs 161–166 discuss acquisition costs.

Acquisition costs

- 161 Insurers often incur significant costs to sell, underwrite and initiate a new insurance contract (acquisition costs). Many existing accounting models measure insurance liabilities initially at the amount of the premium received and defer acquisition costs. Some argue that an insurer should recognise an intangible asset to reflect the initial

* An annuity is a contract that provides a series of regular payments for a specified period. Some annuities have an accumulation phase (when the policyholder is paying premiums) and a payout phase (when the insurer is paying the annuity). An annuity does not transfer insurance risk to the insurer until the basis for the annuity rate is set.

† Chapter 6 discusses universal life contracts.

- investment made to acquire the customer relationship and argue that deferring the acquisition costs results in an appropriate cost-based measurement of that investment. Proponents of this view would then amortise the acquisition costs as the insurer recovers them.
- 162 Consider the following example. For simplicity, this example ignores the time value of money. A contract generates policyholder benefit payments of CU900 (including an acceptable risk margin and service margin). The insurer would want to charge at least CU900 for this contract. Now suppose the insurer has to incur acquisition costs of CU100 to originate the contract. The insurer will now want to charge at least CU1,000.
- 163 Assume the contract generates a single premium of CU1,000, received at inception, and the pricing of the contract provides the insurer with margins that are in line with the margins market participants require. Therefore, at inception, the insurer's obligation has a current exit value of CU900. If the insurer measures the obligation initially at CU900, it will recognise a gain of CU100 (CU1,000 less CU900) and acquisition cost expense of CU100, resulting in profit of nil at inception.
- 164 Put differently, the policyholder is paying CU900 for risk protection and CU100 for the contract origination activity. From the policyholder's perspective, the entire payment of CU1,000 is for risk protection because the policyholder cannot access the risk protection without the origination. However, from the insurer's perspective, the obligation is worth CU900. Indeed, a hypothetical transferee might be willing to take over the liability for CU900. A transferee would not require as much as CU1,000, because the transferee would not need to recover acquisition costs.
- 165 In the Board's preliminary view, recognising a separate intangible asset measured at the amount of acquisition costs incurred and at the same time recognising an insurance liability measured at the amount of the premium received would overstate the insurer's obligation and report an asset that either does not exist (if the insurer recovers acquisition costs from cash already received) or relates to future cash flows included in the measurement of the liability. Instead, acquisition costs should be recognised as an expense, not as the cost of an asset. 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 (using the guaranteed insurability test discussed above).

- 166 Examples 8 (single premium contract) and 9 (regular premium contract) in appendix G illustrate the Board's preliminary views and compare them with alternative presentations that recognise an intangible asset measured by reference to acquisition costs. Among other things, these illustrations demonstrate that a separate measurement of the customer relationship at inception is unlikely to equal the acquisition costs incurred. Moreover, subsequent arbitrary amortisation of deferred acquisition costs is unlikely to be a good proxy for a measurement of the customer relationship, and is not likely to provide useful information.

Insurance contracts acquired in business combinations and portfolio transfers

Business combinations

- 167 IFRS 3 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination. IFRS 4 does not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement.^{*} IFRS 4 permits, but does not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:
- (a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues.
 - (b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). The subsequent measurement of this intangible asset is required to be consistent with the measurement of the related insurance liability. Therefore, that asset is excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38. However, IAS 36 and IAS 38 apply to customer lists and customer relationships reflecting the expectation of renewals and repeat business that are not part of the contractual rights acquired and contractual obligations assumed.

* Paragraphs 31–33 of IFRS 4 and paragraphs BC147–BC153 of the Basis for Conclusions on IFRS 4

- 168 The main purpose of the expanded presentation was to maintain the requirement to measure at fair value the identifiable assets and liabilities acquired, while permitting insurers to continue using existing measurement approaches for insurance liabilities. The Board did not wish to force insurers to make systems changes that could become obsolete in phase II of the project on insurance contracts.
- 169 As noted in chapter 3, it is too early to conclude whether current exit value is the same as fair value. The Board will review that question as work proceeds on this project and on its project on fair value measurements. If any significant differences remain between current exit value and fair value, it may be necessary to consider retaining the expanded presentation. If no significant differences remain, the expanded presentation will become redundant.

Contracts acquired in a portfolio transfer

- 170 The expanded presentation is also available for a block of insurance contracts acquired in a portfolio transfer. There are two main ways to effect a portfolio transfer:
- (a) The transferor may buy reinsurance that requires the reinsurer to indemnify the transferor for all cash outflows, and requires the transferor to pass on all cash inflows to the reinsurer. In this case, the transferor retains the underlying liability and obtains a corresponding reinsurance asset (chapter 5 discusses reinsurance assets). The reinsurer has simply issued a reinsurance contract and would apply the same accounting as all insurers issuing any type of insurance contract.
 - (b) The transferor arranges for its contractual rights and obligations to be transferred to the transferee (or to be cancelled, and replaced by new rights and obligations of the transferee). This typically requires the consent of some or all of a regulator, a court and the policyholders.
- 171 In some cases, a portfolio transfer also involves the transfer of systems (which are sometimes highly specific to a particular portfolio) and staff. In such cases, the transferee would need to consider whether the transaction is a business within the scope of IFRS 3. It is beyond the scope of this project to review the criteria that would be relevant for this assessment.

- 172 If the transferee acquires only the insurance contracts (and perhaps also the related investments), it is necessary to examine the relationship between the consideration for the transfer and the initial measurement of the insurance liabilities. In many cases, the consideration will equal current exit value. If not, the transferee would need to consider first whether it has acquired customer relationships that should be recognised as an intangible asset. An example is a customer relationship that gives rise to the expectation that some policyholders will renew annual motor insurance contracts.* After recognising that intangible asset, how should the transferee recognise any remaining difference (which may be rare)? The Board considered three possibilities:
- (a) Recognise the difference as goodwill. This would not be representationally faithful if the transferee acquires only separately recognisable assets and liabilities (eg insurance liabilities, related reinsurance assets, investments, recognisable customer relationships and deferred tax).
 - (b) Include the difference in the initial measurement of the liability. This would be a departure from the principle of measurement at current exit value.
 - (c) Recognise the difference as income or expense. In the Board's preliminary view, this is the only faithful representation of the transaction.

Summary of preliminary views in this chapter

- 173 The Board has reached the following preliminary views:
- (a) An insurer has an asset relating to its ability to derive net economic benefits from future premiums that the policyholder must pay to retain guaranteed insurability. Guaranteed insurability is a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.
 - (b) The insurer should recognise that asset, and measure it in the same way as the related insurance liability (ie at current exit value).

* An insurer would not recognise an acquired customer relationship as an intangible asset if it is included in the measurement of the liability (eg the expectation that policyholders will continue paying premiums for a long-term life insurance contract that provides guaranteed insurability).

- (c) That asset is part of a customer relationship, not a contractual asset. Nevertheless, the insurer should present that asset as part of the related insurance liability. The insurer need not separate that asset from the liability for recognition, measurement or presentation.
 - (d) An insurer should recognise acquisition costs as an expense when it incurs them. If the insurer expects to recover acquisition costs from future premiums that policyholders must pay to retain guaranteed insurability, those premiums reduce the measurement of the liability because the insurer includes them in the recognised part of the customer relationship. If the insurer recovers acquisition costs from premiums already received, receiving that part of those premiums does not increase the measurement of the liability.
 - (e) IFRS 4 permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer. When the Board completes this project, it may be necessary to retain the expanded presentation if any significant differences remain between current exit value and fair value. If no significant differences remain, the expanded presentation will become redundant.
 - (f) When an entity takes over a portfolio of insurance contracts in a portfolio transfer, the current exit value of the portfolio at that date is likely to equal the consideration received, less the fair value of any other assets received (eg investments or recognisable intangible assets relating to customer relationships). If the current exit value is a different amount, the transferee should recognise the difference as income or expense.
- 174 Some Board members disagree with preliminary views expressed in paragraph 173(a)–(c):
- (a) Some Board members believe that an insurer should not recognise net economic benefits expected from future premiums if the insurer cannot compel the policyholder to pay those premiums. In other contexts, expected benefits of that type do not qualify for recognition, either as an asset or as a reduction in a liability. Recognising those expected benefits for insurance contracts would create inconsistencies with requirements in other IFRSs. This might create opportunities for entities to engineer a desired accounting result by including an insurance contract in an otherwise unrelated contract.

- (b) Some Board members believe that the criterion of guaranteed insurability is open to inconsistent application and abuse. For this reason, and for reasons discussed in chapter 3, they would prohibit the recognition of a profit at the inception of insurance contract. In their view, an insurer should recognise a customer relationship, measured at inception at the amount of acquisition costs incurred, to the extent that those costs are recoverable.
- (c) Some Board members believe that an insurer can measure the recognised part of the customer relationship separately at a cost that does not exceed the benefits to users. They conclude that an insurer should always present the customer relationship separately from the insurance liability. An insurance liability and a customer relationship have different characteristics. Presenting them as a single, net, item obscures that fact. Moreover, a net presentation conflicts with the deposit floor in IAS 39.

Questions for respondents

Question 6

In this paper, beneficial policyholder behaviour refers to a policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer. For expected future cash flows resulting from beneficial policyholder behaviour, should an insurer:

- (a) incorporate them in the current exit value of a separately recognised customer relationship asset? Why or why not?
- (b) incorporate them, as a reduction, in the current exit value of insurance liabilities? Why or why not?
- (c) not recognise them? Why or why not?

Question 7

A list follows of possible criteria to determine which cash flows an insurer should recognise relating to beneficial policyholder behaviour. Which criterion should the Board adopt, and why?

- (a) Cash flows resulting from payments that policyholders must make to retain a right to guaranteed insurability (less additional benefit payments that result from those premiums). The Board favours this criterion, and defines guaranteed insurability as a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.

- (b) All cash flows that arise from existing contracts, regardless of whether the insurer can enforce those cash flows. If you favour this criterion, how would you distinguish existing contracts from new contracts?
- (c) All cash flows that arise from those terms of existing contracts that have commercial substance (ie have a discernible effect on the economics of the contract by significantly modifying the risk, amount or timing of the cash flows).
- (d) Cash flows resulting from payments that policyholders must make to retain a right to any guarantee that compels the insurer to stand ready, at a price that is contractually constrained, (i) to bear insurance risk or financial risk, or (ii) to provide other services. This criterion relates to all contractual guarantees, whereas the criterion described in (a) relates only to insurance risk.
- (e) No cash flows that result from beneficial policyholder behaviour.
- (f) Other (please specify).

Question 8

Should an insurer recognise acquisition costs as an expense when incurred? Why or why not?

Question 9

Do you have any comments on the treatment of insurance contracts acquired in a business combination or portfolio transfer?

Chapter 5 Measurement – other issues

- 175 Chapter 3 discussed the three basic building blocks. This chapter discusses various related issues, which are largely independent of each other:
- (a) assets backing insurance contracts (paragraphs 176–182)
 - (b) unit of account (paragraphs 183–202)
 - (c) reinsurance (paragraphs 203–219)
 - (d) unbundling (paragraphs 220–228)
 - (e) credit characteristics of insurance liabilities (paragraphs 229–232)
 - (f) investment contracts (paragraph 233).

Assets backing insurance contracts

- 176 Many commentators have noted that accounting mismatches could arise in phase I of this project and have expressed the view that eliminating these mismatches should be a major objective of phase II. It costs time and money for insurers to explain volatility caused by accounting mismatches even to sophisticated users. Less sophisticated users may not understand these effects at all.
- 177 It is important to distinguish accounting mismatches from economic mismatches. The Basis for Conclusions on IFRS 4 describes these notions as follows:
- (a) **Economic mismatch** arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. For example, an economic mismatch arises if the duration of insurance liabilities is longer than the duration of fixed interest assets backing those liabilities.
 - (b) **Accounting mismatch** arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes.

- 178 The most prominent reason for accounting mismatches in phase I is measuring insurance liabilities on a basis that does not reflect current interest rates while measuring interest-bearing financial assets at fair value. If interest rates change, the carrying amount of the assets changes but the carrying amount of the insurance liabilities does not change, with the following consequences:
- (a) For financial assets classified as ‘at fair value through profit or loss’, there is an accounting mismatch in the income statement and the balance sheet.
 - (b) For ‘available-for-sale financial assets’, there is no accounting mismatch in the income statement (unless the assets are sold), but there is an accounting mismatch in equity.
 - (c) If the insurer sells assets, an accounting mismatch occurs not only for available-for-sale financial assets, but also for assets carried at amortised cost.
- 179 An ideal measurement model would report all economic mismatches that exist and would not cause any accounting mismatches. In assessing how to achieve this, the Board considered cost-based approaches and current estimate approaches. Cost-based approaches use cost-based measurements (such as the ‘lock in’ approach discussed in chapter 3) for insurance liabilities and extend the use of cost-based measurements for assets held to back those liabilities. Proponents of these approaches offer the following arguments:
- (a) These approaches may reduce some of the accounting mismatch that can arise if interest-sensitive financial assets are carried at fair value but related insurance liabilities are carried on a basis that does not reflect current interest rates.
 - (b) Insurers often follow a strategy that involves holding fixed maturity investments to maturity but retains some flexibility to sell investments if insurance claims or lapses are unusually high.
 - (c) A precedent exists in Japan for creating a new category of assets carried at amortised cost: assets held to back insurance liabilities.
- 180 Current estimate approaches measure insurance liabilities using current estimates and reflecting current market conditions. For the following reasons, the Board’s preliminary view is that current estimate approaches will provide more relevant and reliable information for users than cost-based approaches:

- (a) Accounting mismatches for insurers arise today more from unsatisfactory measurements of insurance liabilities than from deficient measurements of assets. Chapter 3 explains the Board’s preliminary view that current estimate approaches will provide the most relevant and reliable information about insurance liabilities.
- (b) Cost-based approaches might eliminate some accounting mismatch, but only at the cost of obscuring some economic mismatch between assets and liabilities. Obscuring the economic mismatch would not make an insurer’s financial statements more relevant and reliable. Financial analysts often observe that information about economic mismatch is important to them: in its response to ED 5 *Insurance Contracts*, the CFA Institute* urged the Board not to extend the use of amortised cost in IAS 39.
- (c) A cost basis for assets permits entities to manage profit by selling selected assets. To limit the scope for this, some jurisdictions have adopted artificial smoothing mechanisms to spread realised gains, but these mechanisms do not enhance transparency.
- (d) Any extension of cost-based measurements of assets would need some discipline on its use. Such discipline might include rigorous designation and documentation at inception, continuous monitoring, procedures to identify the effect of economic mismatches, and restrictions (perhaps similar to the ‘tainting’ rules in IAS 39) for disposals. Such disciplines would inevitably be arbitrary and would increase the complexity of IAS 39. Moreover, it is likely that few insurers would use an amortised cost category that was subject to such significant constraints. In discussions with individual Board members and staff during the finalisation of IFRS 4, insurers generally indicated that they wished to keep the flexibility to sell assets in the light of changing demographic and economic conditions so that they can seek the best trade-off between risk and return. That is a valid and understandable business objective. However, if an entity might sell assets in response to changing market and other conditions or a liquidity shortage, fair value is more relevant than amortised cost. Although IFRS 7 *Financial Instruments: Disclosures* requires disclosure of the fair value of financial assets carried at amortised cost, disclosure does not rectify inappropriate measurement.

* The CFA Institute is an international, not-for-profit organisation of more than 70,000 investment practitioners and educators in over 100 countries. When it commented on ED 5, it was known as the Association for Investment Management and Research.

- (e) Paragraph 179(c) mentions a precedent in Japan. That precedent is an option to measure assets at amortised cost. The Japanese precedent creates some discipline by placing restrictions on the use of the option, but:
 - (i) the restrictions require significant documentation and internal control systems. Some view the restrictions as too burdensome. As a result, not all insurers in Japan use the option.
 - (ii) the Japanese requirements permit a cost approach if the durations (ie average maturities) of insurance liabilities match those of the related assets within a specified band of 80–125 per cent. If any economic mismatch arises within that band, this approach does not recognise it.
 - (iii) gains and losses on selling assets measured at amortised cost are generally recognised immediately in profit or loss (but some gains are deferred and amortised if sales are not compatible with the duration matching strategy).
 - (f) Assets ‘held to back insurance liabilities’ cannot be defined without ambiguity.
 - (g) The cash flows from an asset do not depend on the purpose for which it is held. Therefore, the purpose is not relevant to a measurement of the asset.
 - (h) Extending the use of amortised cost would be inconsistent with the Board’s long-term objective of requiring all financial instruments to be measured at fair value, and would, in the shorter term, create an inconsistency with US GAAP.
- 181 Some IFRSs contain options that enable insurers to avoid most accounting mismatches. Examples include the options to classify most financial assets at fair value through profit or loss and to use the fair value model for investment property. The Board expects that insurers would typically use these options to minimise accounting mismatches. However, the Board does not intend to require insurers to exercise those options. Such a requirement would add unnecessary complexity and it would be difficult to define when it would apply.
- 182 In this project, the Board does not intend to change existing IFRSs (eg IAS 39) for assets held by insurers. Under IFRSs, some assets cannot be classified as ‘at fair value through profit or loss’ (eg treasury shares, owner-occupied property or goodwill of subsidiaries). The Board does not

intend to permit or require insurers to use that classification for these assets, even if they hold them to back insurance contracts. Chapter 6 discusses some specific accounting mismatches that could arise when an insurer holds these assets to back index-linked contracts.

Unit of account

- 183 What should be the unit of account for insurance contracts? For example, is the unit of account an individual contract or some higher level of aggregation? The following paragraphs consider whether the unit of account affects recognition and measurement.

Recognition

- 184 As discussed in chapter 4, the Board's consideration of policyholder behaviour is based on an analysis of rights and obligations associated with individual contracts. Aggregating contracts into a portfolio creates no new contractual rights or obligations, nor does it eliminate existing contractual rights or obligations. Therefore, the unit of account is not relevant to the resolution of these recognition issues.

Measurement

- 185 Insurance professionals generally argue that insurers should measure their rights and obligations under insurance contracts on a portfolio basis, rather than contract by contract. The following paragraphs discuss two questions:
- (a) Does a portfolio measurement differ from a contract-by-contract measurement? In particular, does the unit of account affect the expected present value of future cash flows (paragraphs 186–189) or risk margins (paragraphs 190–198)?
 - (b) If portfolio effects have a role in measurement, how should the unit of account be determined (paragraphs 199–201)?

Expected present value of future cash flows

- 186 Some have suggested that the expected value notion is relevant only for a portfolio, not for an individual contract. However, in principle, the expected (probability-weighted) cash flows from a portfolio equal the sum of the expected cash flows of the individual contracts. Therefore, the unit of account does not affect the expected present value of future cash flows.

- 187 In practice, it is easier to perform some types of estimate in aggregate for a portfolio, rather than for individual contracts. For example, IBNR (incurred but not reported) estimates are typically made in aggregate. However, in principle, this is no different from making expected value estimates for individual contracts and aggregating the results. Thus, the unit of account does not affect the expected cash flows, provided that estimates of cash flows reflect all relevant inputs. Some of those inputs might be derived by contract (eg estimates of the possible outcomes of a single claim) and others might be derived in aggregate (eg IBNR).
- 188 If the unit of account is the contract, some might argue that estimated cash flows should exclude expenses that are not incremental. Incremental expenses are expenses that the insurer will incur because of a particular contract and that it would have avoided if it did not have that contract. However, excluding non-incremental expenses would not be consistent with using current exit value as the measurement attribute. A hypothetical transferee would consider all expenses necessarily incurred in servicing the contract, regardless of whether those expenses are incremental.
- 189 When participating policyholders share collectively in income or profits generated by a pool of contracts, an insurer may need to measure that effect in aggregate, not contract by contract.

Risk margins

- 190 The following paragraphs consider whether risk margins should be determined for each insurance contract individually and then aggregated, or determined directly for some higher level of aggregation. As a preliminary, it is worth considering how aggregation might affect the level of risk. Insurance professionals sometimes distinguish between the following three techniques:
- (a) pooling of risk (assembling a balanced portfolio of reasonably homogeneous risks to permit reasonable estimates of the behaviour of the pool as a whole). For example, a life insurer might assemble a portfolio of policyholders who are believed to have similar mortality characteristics. In doing this, the insurer will consider the trade-off between (i) the need to have a large pool that minimises random fluctuations in claims and (ii) the need to subdivide the population into smaller pools with more uniform risk characteristics (eg by age, sex, occupation, smoker status or location).

- (b) diversification of risk (collecting different risks generating random fluctuations that tend, on average, to cancel each other out). For example, a multi-line insurer diversifies risk by selling many different types of insurance, although that diversification is less effective if the results of the different types are correlated. Similarly, by investing in a large number of entities, a mutual fund reduces the risk of large fluctuations caused by factors specific to a particular investee, but does not reduce the risks that are common to all investees (eg business cycle or interest rates).
- (c) hedging of risk (collecting risks that are negatively correlated so that adverse outcomes for one item tend to be offset by favourable outcomes for other items). For example, term life insurance exposes the insurer to the risk that policyholders will die prematurely, whereas annuities expose the insurer to the risk of unexpected longevity. An insurer issuing both types of contract is likely to suffer less fluctuation in total claims than an insurer that issues only one type of contract.

191 Some argue that a risk margin will be lower if it is determined for a portfolio than if it is determined for each contract and then aggregated, or proportionately lower for a larger portfolio than for a smaller portfolio. Proponents of this view identify four factors that might be relevant:

- (a) statistical evidence (paragraph 192)
- (b) adverse selection (paragraphs 193 and 194)
- (c) random fluctuations and diversifiable risk (paragraphs 195–199)
- (d) diversification and negative correlations (paragraphs 200 and 201).

Statistical evidence

192 For a small portfolio, there is less statistical evidence about the process driving future cash flows and its parameters. This increases the risk that the insurer will select the wrong model (model risk) or mis-estimate the parameters (parameter risk). However, the measurement of a portfolio should reflect all available information about that portfolio, not just information that originates within the portfolio itself. Thus, the insurer uses the same statistical evidence, regardless of whether it measures the portfolio contract by contract or at a higher level of aggregation.

Adverse selection

- 193 A large portfolio may provide some protection against adverse selection (risk that new or continuing policyholders will be drawn disproportionately from higher-risk groups). For this reason, a transferee would prefer to take a whole portfolio, rather than individual contracts selected by the transferor.
- 194 It follows that an insurer would not normally transfer individual contracts out of a portfolio because the price would be extremely disadvantageous to the transferor, to protect the transferee against adverse selection. Therefore, the only transaction that could plausibly occur is a transfer of a portfolio of contracts that forms a natural unit, so minimising the transferee's fear of adverse selection. This suggests that the risk margin should not consider the additional risk of adverse selection that would be present in a transfer of individual contracts.

Random fluctuations and diversifiable risk

- 195 A small portfolio is proportionately more exposed than a large portfolio to random fluctuations. For example, if a coin is tossed once, the average number of heads is 0.5 with a standard deviation of 0.5. For 100 coin tosses, the average number of heads is 50, with a standard deviation of 5, which is only 10 times the standard deviation for one coin toss. In other words, the risk of random fluctuations can be reduced by diversification.
- 196 Some asset pricing models, such as the capital asset pricing model (CAPM), are based on the proposition that efficient markets do not reward participants for bearing risks that they can diversify away. In these models, risk margins relate only to risks that are not diversifiable.* However, insurance professionals typically reason that both diversifiable and undiversifiable risks are relevant, on the following grounds:
- (a) CAPM and similar models are based on idealised assumptions, such as a perfect and liquid market, rational behaviour by investors, minimal transaction costs and the existence of arbitrage traders whose activities will force market prices to converge to levels that eliminate arbitrage opportunities. Arguably, these assumptions do not apply in most insurance markets.
 - (b) Because there is a cost to obtaining information, risks that are diversifiable in theory may not be fully diversifiable in practice.

* Whether or not the risk margin reflects diversifiable risks, those risks still affect the expected value.

- (c) Reinsurers sometimes charge lower premiums than a direct insurer for the same exposure. One reason for such differences may be that the reinsurer is diversifying the exposure more broadly. Some see that as evidence that insurers' pricing models include diversifiable risk.
- 197 In principle, the proposition that efficient markets do not reward participants for bearing diversifiable risk is attractive. However, it seems likely that practical techniques for determining risk margins will not be able to exclude the effect of diversifiable risks. Actuaries and other insurance professionals are now focusing most of their development work on two techniques for estimating the risk margin that market participants would require:
- (a) cost of capital approaches assess how much economic capital market participants would need to hold if they bear the risk in question, and determine the cost to market participants of holding that capital.
 - (b) quantile and related approaches set a margin equal to a given point on the estimated probability distribution (eg the 75th percentile), a multiple of the standard deviation or of the variance, or the expected value of the tail of a probability distribution (known as conditional tail expectation, Tail Value at Risk, or Tail VaR).
- 198 Both cost of capital approaches and quantile approaches typically use inputs that measure the variability of cash flows of a portfolio. The extent of that variability depends on the size of the portfolio. Thus, these approaches will inevitably reflect benefits of pooling within the portfolio. Conceptually, some view this as appropriate and others view it as inappropriate, but there seems to be no practical way to exclude the effects of pooling within a portfolio. Also, measuring risk margins for a portfolio is consistent with insurers' pricing and risk management. The essence of an insurer's business is to pool the risks transferred by individual contracts. Insurers do not price individual contracts in isolation, they price them with a view to including them in a portfolio. Determining risk margins for individual contracts and then aggregating those margins is likely to be both difficult and of limited relevance to users.

Defining the unit of account

- 199 The above comments on adverse selection and on random fluctuations suggest that the natural starting point for measuring risk margins is a portfolio of contracts, not individual contracts. How might a portfolio of contracts be defined? Some suggest that the unit of account should be ‘a group of contracts that are managed together when assessing risk’. IFRS 4 refers to a liability adequacy test for a ‘portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio’. The two descriptions are broadly similar and neither is watertight. The Board sees no obvious way to improve them significantly. In the Board’s preliminary view, the description from IFRS 4 is preferable because the additional reference to ‘broadly similar risks’ creates a slightly tighter definition.

Diversification between portfolios and negative correlations between portfolios

- 200 Insurers benefit from diversification between portfolios (although those benefits may be limited if capital is not fungible: in other words, if excess capital in one portfolio is not fully and immediately available to cover capital shortages in other portfolios). They also benefit from risks that are negatively correlated with the risks from other portfolios (eg term life insurance and annuities). If the unit of account includes both portfolios, the risk margin reflects the benefits of diversification between the portfolios and also the negative correlations between them. Conversely, if each portfolio is a separate unit of account, the risk benefit will not reflect diversification, and negative correlations, between the portfolios.
- 201 Some argue that risk margins should reflect the effects of diversification between portfolios. They argue that users are interested in the risks faced by an entity as a whole. Moreover, diversified insurers may be able to charge lower premiums. Thus, reflecting diversification benefits may be consistent with observed pricing behaviour. However, the Board notes that current exit value should be independent of the entity that holds the asset or liability. Therefore, the Board concluded that risk margins should be determined for each portfolio in isolation and should not consider diversification between portfolios.

Summary of preliminary views on unit of account

- 202 The Board's preliminary views are as follows:
- (a) The unit of account does not affect the expected present value of future cash flows.
 - (b) Risk margins should be determined for a portfolio of insurance contracts that are subject to broadly similar risks and managed together as a single portfolio. Risk margins should not reflect the benefits of diversification between portfolios and negative correlation between portfolios.

Reinsurance

Reinsurance liabilities

- 203 The Board's preliminary view is that reinsurers should measure reinsurance liabilities at current exit value. In other words, the same requirements would apply to both direct insurance liabilities and reinsurance liabilities.

Reinsurance assets

- 204 As noted in chapter 2, the Board does not intend to change the following existing requirements of IFRS 4:
- (a) An insurer does not derecognise insurance liabilities until the contractual obligations are extinguished (by discharge, cancellation or expiry).*
 - (b) A cedant (ie the insurer holding reinsurance) does not offset reinsurance assets against related insurance liabilities, and does not offset reinsurance income and expense against related insurance expense and income.†

* IFRS 4, paragraph 14(c)

† IFRS 4, paragraph 14(d)

- 205 Given the Board's preliminary view that a cedant should measure the underlying direct insurance liability at current exit value, the Board's preliminary view is that current exit value should also be the measurement attribute for reinsurance assets. The following paragraphs discuss various aspects of reinsurance assets:
- (a) margins for the risk associated with the underlying insurance contracts (paragraphs 206–210)
 - (b) impairment (paragraphs 211–214)
 - (c) gains and losses on buying reinsurance (paragraphs 215–217)
 - (d) non-overlapping periods of coverage (paragraph 218).

Margins for risk associated with the underlying insurance contract

- 206 In general, risk margins **reduce** the current exit value of an asset. However, for reinsurance assets, the risk margin relating to the risk associated with the underlying insurance contract **increases** the current exit value. Moreover, that risk margin equals the risk margin for the corresponding part of the underlying insurance contract. Table 5.1 illustrates these points.

Table 5.1 Risk margin in a reinsurance asset

Insurer A has an insurance liability with expected (ie probability-weighted) cash outflows of CU100. Insurer A estimates that the current exit value of the liability is CU120 (ie expected cash outflows of CU100 plus a risk margin of CU20). For simplicity, this example ignores the time value of money. Insurer A pays a premium of CU36 to reinsure 30 per cent of the liability on a proportionate basis.

At inception, the current exit value of insurer A's reinsurance asset is CU36 (ie expected value of CU30 **plus** risk margin of CU6).

This example addresses simple proportional reinsurance, but similar principles apply for more complex reinsurance coverage (eg stop loss contracts). In other words, the risk margin for the reinsurance asset would equal the risk margin for the corresponding part of the underlying insurance contract.

- 207 It is not surprising that the reinsurer charges more than expected value to obtain an acceptable profit margin. But the price of an asset is normally less than the expected value of the cash flows it will generate. Why would a risk-averse entity willingly pay more than the expected value? The reason is that the reinsurance contract pays out precisely when the cedant most needs the money, ie when it has just suffered a large loss.
- 208 This explains why a policyholder (the cedant, in this case) is willing to pay more than expected value for insurance. How does that fact relate to current exit value? A reinsurance contract will pay out only if the cedant has suffered a loss caused by an insured event covered by the reinsurance contract. Therefore:
- (a) a cedant's rights under the contract typically have value only for the cedant, because a potential transferee could not claim under the contract if the transferee does not have an insurable interest in the underlying insurance contract. A cedant could not transfer those rights to a third party unless the cedant simultaneously transfers to the same party the cedant's contractual rights and obligations flowing from the underlying insurance contract.*
 - (b) the reinsurance contract would not pay out if the cedant has not suffered a loss. Hence, if a cedant transferred the underlying contracts, it would also want to transfer the reinsurance contracts at the same time, because otherwise the reinsurance contract would have no value.
- 209 It follows that the reference transaction for determining the current exit value of the reinsurance asset is a simultaneous transfer of both the reinsurance contract and the related underlying contract(s). The reinsurance contract reduces the variability of net cash flows from the two contracts. Therefore, uncertainty about the cash flows from the underlying contract increases, rather than decreases, the value of the reinsurance contract to any party holding that contract.
- 210 For non-proportional insurance (eg stop loss insurance), the cash flows (and risk margin) are often less variable after reinsurance than before reinsurance. Sometimes, the most practical approach is to estimate the cash flows and risk margin after reinsurance (taking care to consider changes over time in the nature and extent of reinsurance), and then

* A transfer of the rights and obligations under the underlying contract typically requires the consent of the policyholder, regulator or both.

gross them up to determine the cash flows and risk margins before reinsurance. In this context, the following factors will influence materiality judgements:

- (a) The after-reinsurance amounts affect the cedant's profit and equity directly.
- (b) The gross-up of the after-reinsurance amounts affects the cedant's profit and equity only indirectly, through the risk of default or dispute. The carrying amount of the reinsurance asset indicates the extent of that risk. In many cases, it may be acceptable to determine the gross-up more approximately than would be acceptable for the after-reinsurance amounts.

Reinsurance assets: impairment

- 211 A cedant faces the risk that the reinsurer may default, or may dispute whether a valid claim exists for an insured event. There are two possible approaches to this risk:
 - (a) Incurred loss model: losses should be recognised only when an event, occurring after initial recognition of an asset, provides objective evidence that the asset is impaired.
 - (b) Expected loss model: reduce the carrying amount for expected (probability-weighted) losses from default or disputes, with a further reduction to reflect the risk that defaults or disputes exceed expected value.
- 212 Proponents of an incurred loss model argue that it provides more objectivity than an expected loss model and is consistent with IAS 39, which adopts this model for impairment of financial assets. IFRS 4 adopts an incurred loss model for reinsurance assets.
- 213 However, the Board's preliminary view is that an expected loss model is appropriate for reinsurance assets. In other words, the current exit value of the reinsurance asset incorporates a reduction for the expected (probability-weighted) present value of losses from default or disputes, with a further reduction for the margin that market participants would require for bearing the risk that defaults or disputes exceed expected value.

- 214 This is consistent with a measurement model that starts with the expected present value of cash flows, including current exit value. Moreover, the Board's aim in requiring the incurred loss model in IFRS 4 was to achieve consistency with IAS 39 in a context where most measurements of the underlying insurance liabilities were not in a full current estimate framework. That context is no longer relevant in phase II, given the Board's preference for current estimate models.

Gains and losses on buying reinsurance

- 215 National accounting requirements often try to address a concern that reported profit might be distorted by the timing of the decision to buy reinsurance. Such distortions are a particular concern if contracts have the legal form of reinsurance but do not transfer significant insurance risk (sometimes known as financial reinsurance).
- 216 One source of such distortions is using an undiscounted measurement basis for many non-life insurance claims liabilities. If the insurer buys reinsurance, the premium paid to the reinsurer reflects the present value of the liability and is, therefore, less than the previous carrying amount of the liability. Reporting a gain on buying the reinsurance does not represent the transaction faithfully if no economic gain occurred at that time. The accounting gain arises largely because of the failure to use discounting for the underlying liability. Similar problems arise if the underlying insurance liability is measured with excessive prudence. If insurance contracts are measured at current exit value, these distortions will largely disappear and would not arise when an insurer buys reinsurance. Therefore, there will be no need for specific restrictions on the recognition of such gains.
- 217 Although both the cedant and reinsurer would measure their contractual rights and obligations at current exit value, in practice they would not necessarily determine the same amount (ie there is no 'mirror accounting'). Possible reasons for differences include different knowledge, different units of account and, if the risk margin is not calibrated at inception to the contractual premium, different calibrations of the risk margin. Chapter 3 discusses the initial calibration of the risk margin. That discussion applies equally to the cedant and the reinsurer.

Non-overlapping periods of coverage

- 218 A reinsurance contract may not cover the same period as the underlying contract. For example, suppose a proportional reinsurance contract covers 30 per cent of each direct contract issued in a calendar year and meeting specified criteria. At 1 July, the cedant may expect to issue further direct contracts during the rest of the year. If the reinsurance contract is not cancellable, the reinsurance contract gives the cedant a contractual right to obtain reinsurance. That right has some value to the cedant, and current exit value would reflect that value, even though the new contracts to be issued do not yet qualify for recognition. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

Summary of preliminary views on reinsurance

- 219 The Board has reached the following preliminary views:
- (a) Reinsurers should measure reinsurance liabilities at current exit value.
 - (b) Cedants should measure reinsurance assets at current exit value.
 - (c) For risks associated with the underlying insurance contract, a risk margin typically:
 - (i) increases the measurement of the reinsurance asset.
 - (ii) is equal in amount to the risk margin for the corresponding part of the underlying insurance contract.
 - (d) The current exit value of reinsurance assets incorporates a reduction for the expected (probability-weighted) present value of losses from default or disputes, with a further reduction for the margin that market participants would require for bearing the risk that defaults or disputes exceed expected value. This is an expected loss model, not the incurred loss model required by IFRS 4 and IAS 39.
 - (e) In principle, a cedant should recognise at current exit value its contractual right, if any, to obtain reinsurance for contracts that it has not yet issued. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

Unbundling

- 220 Because the policyholder must generally pay premiums in advance, virtually all insurance contracts have an implicit or explicit deposit component that would, if it were a separate instrument, be within the scope of IAS 39. Some examples of deposit components are:
- (a) the surrender value or maturity value of an endowment. These contracts might be viewed as a combination of (i) that deposit component and (ii) an insurance component that pays the difference between the death benefit and the surrender value if the policyholder dies before the contract matures.
 - (b) components for which a policyholder assumes all or most of the investment risks (as with some types of unit-linked (variable) contract).
 - (c) an interest-bearing account value, as in some universal life contracts.
 - (d) some experience accounts and similar mechanisms in some reinsurance contracts and some direct insurance contracts for corporate policyholders. IG Example 3 of the Guidance on Implementing IFRS 4 illustrates a contract with such a feature.
 - (e) ‘excess’ premiums pre-paid in the early years of a long-term life insurance or health insurance contract to fund ‘excess’ benefits in later years.
 - (f) components that are completely separable or have been combined artificially with insurance components that behave economically as separate contracts.
- 221 Different measurement models co-exist in IFRSs now. Therefore, a deposit component of an insurance contract may not receive the same accounting treatment as a separate deposit contract. Similarly, a separate service contract may not receive the same treatment as a service component of an insurance contract. The relevant measurement models in IFRSs are as follows:
- (a) In phase I, rights and obligations under insurance contracts are measured using various bases, mostly inherited from pre-existing national practices. Applying the Board’s preliminary views, rights and obligations under insurance contracts would be measured in phase II at current exit value.
 - (b) Financial instruments are measured at amortised cost or fair value.

- (c) Revenue from service contracts is recognised by reference to the stage of completion of the transaction (see IAS 18 *Revenue*)*. The nominal amount of revenue received in advance is recognised as a liability. The appendix to IAS 18 gives specific guidance on investment management fees.
- 222 The Board's preliminary views would reduce the differences between these models, but not eliminate them. Inconsistencies may still remain if:
- (a) an insurer does not classify financial instruments as at fair value through profit or loss. In most cases an insurer can use the fair value option in IAS 39 to avoid this inconsistency.
 - (b) the IAS 18 model is used to recognise revenue from stand-alone service contracts (or from service contracts embedded in long-term savings contracts), but for a servicing component of insurance contracts an insurer reports revenue when service margins are no longer needed.
- 223 To minimise these inconsistencies, some argue that an insurer should account for any deposit component or service component separately from the insurance component. This separation ('unbundling') has some or all of the following consequences:
- (a) measurement consequences:
 - (i) The insurance component is measured as an insurance contract.
 - (ii) The deposit component is measured under IAS 39 at either amortised cost or fair value. This might or might not differ from the basis used for insurance contracts.
 - (iii) An obligation to provide services (eg investment management) is typically measured under IAS 18 at the unearned part of any consideration received in advance. This may differ from current exit value if circumstances have changed significantly since inception, or if an initial measurement at current exit value led to a profit at inception.

* IAS 18, paragraphs 20–28

- (iv) For deposit components measured at amortised cost, the related incremental transaction costs are deducted in determining the initial carrying amount, not recognised as an expense.
 - (b) presentation consequences, discussed in chapter 7:
 - (i) Premium receipts for the deposit component are presented as changes in the deposit liability, not as revenue. Premium receipts for the insurance component are typically presented as revenue in current practice, but chapter 7 discusses whether this should continue.
 - (ii) If the deposit component is regarded as third-party funds under management, rather than as a direct obligation of the insurer, the deposit component might be reported off balance sheet. This is how most fund managers account for mutual funds that they manage.
- 224 IFRS 4 requires an insurer to unbundle an insurance contract if the rights and obligations arising from the deposit component (a) can be measured separately and (b) would not otherwise be recognised. If only the first of these conditions is met, IFRS 4 permits unbundling, but does not require it.* The Board's objective was to require unbundling only when it is easiest to perform and the effect is likely to be greatest (eg for some large customised financial reinsurance contracts).† The Board did not wish to require unbundling in cases where phase II might not require it.

Arguments for unbundling

- 225 Supporters argue that unbundling of deposit components would:
- (a) mean that an entity accounts in the same way for the deposit component of an insurance contract as the issuer of a separate, but otherwise identical, financial instrument (eg one issued by a bank or a fund manager).
 - (b) avoid sharp discontinuities in the accounting between a contract that transfers just enough insurance risk to be an insurance contract, and another contract that falls marginally on the other side of the line. This would reduce the pressure on the definition of insurance contract.

* IFRS 4, paragraphs 10–12 and Guidance on Implementing IFRS 4, paragraph IG5 and IG example 3.

† Basis for Conclusions on IFRS 4, paragraphs BC40–BC54.

- (c) distinguish between premium revenue earned for accepting insurance risk and premium receipts that are, in substance, investment or deposit receipts. Chapter 7 discusses how insurers should present premiums.

Arguments against unbundling

226 Opponents of unbundling give the following arguments:

- (a) The components are closely interrelated and the value of the bundled product may differ from the sum of the individual values of the components.
- (b) Insurance contracts are designed, priced, managed and regulated as packages of benefits. Furthermore, the insurer cannot unilaterally terminate the agreement or sell parts of it. Any unbundling required solely for accounting would be artificial and often require significant and costly systems changes.
- (c) Surrender options may cause interdependencies between the components. In principle, the deposit component does not include the part of the surrender value needed to compensate the policyholder for forfeiting the right to future insurance coverage. However, it may not be straightforward to identify that part. Thus, the measurement of the deposit component might be arbitrary in some cases.
- (d) Some users want information about gross premium inflows, as an indicator of new business activity. They would prefer that either all products are unbundled or no products are unbundled.

227 Some favour unbundling for some types of deposit component, but not for all types.

Preliminary view on unbundling

228 In the Board's preliminary view, if an insurance contract contains both an insurance component and a deposit component, the insurer should treat it as follows:

- (a) if the components are so interdependent that the components can be measured only on an arbitrary basis, the phase II standard on insurance contracts should apply to the whole contract.
- (b) if the components are not interdependent, the phase II standard should apply to the insurance component and IAS 39 should apply to the deposit component.

- (c) if the components are interdependent but can be measured separately on a basis that is not arbitrary, IAS 39 should apply to the deposit component. The whole contract would be measured by applying the phase II standard. Consequently, the insurance component would be measured as the difference between the measurement of the whole contract and the measurement of the deposit component.

Credit characteristics of insurance liabilities

- 229 This section discusses briefly whether the measurement of insurance liabilities should reflect their credit characteristics. Appendix H contains a more detailed discussion.
- 230 Some argue that the measurement of insurance liabilities should not reflect their credit characteristics. They provide the following arguments:
- (a) Measuring insurance liabilities on a basis that reflects their credit characteristics would be inconsistent with the fact that insurers intend to meet all valid claims in full and that insurance supervisors would require them to do so.
 - (b) Adjustments for credit characteristics are irrelevant if an insurer cannot realise them by transferring the liabilities to another party.
 - (c) Adjustments for the credit characteristics of liabilities may not be reliably measurable, especially if not calibrated to the actual premium charged.
 - (d) If an insurer's reported insurance liabilities decline with an impairment of their credit characteristics, users may find it more difficult to assess the insurer's financial strength.
 - (e) A decline in an insurer's credit standing would normally occur at the same time as an impairment of internally generated goodwill, which is not recognised as an asset. Because that impairment is not recognised as an expense, it would be misleading to recognise income as a result of the decline in the insurer's credit standing.
 - (f) If income is recognised when the credit characteristics of liabilities change, that amount will, if there is no default, reverse in later periods as an expense.

- 231 Others argue that the measurement of insurance liabilities should reflect their credit characteristics. They provide the following arguments:
- (a) Few people doubt that the initial measurement of debt issued for cash should reflect the credit characteristics of the debt. There is no obvious reason to treat insurance liabilities differently.
 - (b) A measurement model is inconsistent if it includes the credit characteristics of liabilities at inception but ignores them later, or ignores subsequent changes in their effect.
 - (c) If current exit value is the measurement attribute for insurance liabilities, it would be arbitrary to exclude the effect of the insurer's credit standing from the measurement.
 - (d) The exclusion of credit characteristics ignores scenarios in which some or all contractual cash outflows do not occur. That is incompatible with measurements based on expected values (ie probability-weighted averages of all scenarios).
 - (e) In many cases, the liability of an insurer's owners is limited to the capital they contributed. The exclusion of credit characteristics ignores that fact by implying that the insurer will meet its obligations in full in scenarios when its assets are insufficient. It is also incompatible with pricing and measurement models based on economic or regulatory capital, because those models apply no explicit risk margin to scenarios in which that capital is exhausted.
 - (f) Reporting changes in the credit characteristics of a liability is intended not to signal the potential for realising a gain, but to use estimated market prices as a benchmark in presenting economically relevant information about the liability.
- 232 The Board's preliminary views are as follows:
- (a) The current exit value of a liability is the price for a transfer that neither improves nor impairs its credit characteristics. The transferor would not willingly pay the price that a willing transferee would require for a transfer that improves those characteristics. The policyholder (and regulator, if any) would not consent to a transfer that impairs those characteristics. If an insurer measures its insurance liabilities at current exit value, that measurement should reflect the liability's credit characteristics.

- (b) An insurer should disclose the effect that the credit characteristics of an insurance liability have on its initial measurement and subsequent changes in their effect. The Board notes that a policyholder is unlikely to buy insurance if the policyholder thinks the insurer may not satisfy its obligations in full. Therefore, the credit characteristics of an insurance liability are unlikely to have a material effect on its current exit value at inception.

Investment contracts

- 233 Many insurers issue some contracts that are within the scope of IAS 39 because they do not transfer significant insurance risk. Appendix B summarises differences between the Board's preliminary views on insurance contracts and existing requirements in IAS 39 and IAS 18 *Revenue*. In principle, the Board would prefer to eliminate those differences. However, the Board has not yet assessed whether that will be appropriate. Thus, this paper includes no specific proposals for such contracts.

Questions for respondents

Question 10

Do you have any comments on the measurement of assets held to back insurance liabilities?

Question 11

Should risk margins:

- (a) be determined for a portfolio of insurance contracts? Why or why not? If yes, should the portfolio be defined as in IFRS 4 (a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio)? Why or why not?
- (b) reflect the benefits of diversification between (and negative correlation between) portfolios? Why or why not?

Question 12

- (a) Should a cedant measure reinsurance assets at current exit value? Why or why not?
- (b) Do you agree that the consequences of measuring reinsurance assets at current exit value include the following? Why or why not?
 - (i) A risk margin typically increases the measurement of the reinsurance asset, and equals the risk margin for the corresponding part of the underlying insurance contract.
 - (ii) An expected loss model would be used for defaults and disputes, not the incurred loss model required by IFRS 4 and IAS 39.
 - (iii) If the cedant has a contractual right to obtain reinsurance for contracts that it has not yet issued, the current exit value of the cedant's reinsurance asset includes the current exit value of that right. However, the current exit value of that contractual right is not likely to be material if it relates to insurance contracts that will be priced at current exit value.

Question 13

If an insurance contract contains deposit or service components, should an insurer unbundle them? Why or why not?

Question 14

- (a) Is the current exit value of a liability the price for a transfer that neither improves nor impairs its credit characteristics? Why or why not?
- (b) Should the measurement of an insurance liability reflect (i) its credit characteristics at inception and (ii) subsequent changes in their effect? Why or why not?

Question 15

Appendix B identifies some inconsistencies between the proposed treatment of insurance liabilities and the existing treatment under IAS 39 of financial liabilities. Should the Board consider changing the treatment of some or all financial liabilities to avoid those inconsistencies? If so, what changes should the Board consider, and why?

Chapter 6 Policyholder participation

- 234 This chapter discusses four types of contracts for which payments to policyholders depend partly on the performance of the portfolio of which the contract forms a part, the assets backing that portfolio or the entity that issued the contract:
- (a) participating contracts (paragraphs 235–261)
 - (b) universal life contracts (paragraphs 262–268)
 - (c) unit-linked contracts (paragraphs 269–286)
 - (d) index-linked contracts (paragraphs 287 and 288).

Participating contracts

- 235 This section discusses participating contracts under the following headings:
- (a) background (paragraphs 236–238)
 - (b) how do participating contracts work? (paragraphs 239–246)
 - (c) definition of a liability (paragraphs 247–253)
 - (d) preliminary views (paragraphs 254–258)
 - (e) measurement of participating contracts (paragraphs 259–261).

Background

- 236 Some insurance contracts, and some investment contracts sold by insurers, give the policyholder both guaranteed benefits (eg a death benefit) and a right to participate in favourable performance of the relevant class of contracts, related assets or both. The insurer has some discretion over the amount or timing of the resulting distributions to policyholders, but there are often constraints over that discretion. In this respect, participating contracts differ from unit-linked contracts, for which such discretion does not exist. This paper describes a policyholder's right to participate in favourable contract performance as a policyholder participation right, and a contract that contains such a right as a participating contract. Other terms, such as with profits contract, are sometimes used to refer to such a contract.

- 237 For convenience, this paper uses these generic terms rather than the more formal and specific term ‘discretionary participation feature’ (DPF) introduced by IFRS 4. This paper does not discuss whether phase II should amend the definition of a DPF. The Board will review that definition later in this project. IFRS 4 defines a DPF as a ‘contractual right to receive, as a supplement to guaranteed benefits, additional benefits:
- (a) that are likely to be a significant portion of the total contractual benefits;
 - (b) whose amount or timing is contractually at the discretion of the issuer; and
 - (c) that are contractually based on:
 - (i) the performance of a specified pool of contracts or a specified type of contract;
 - (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
 - (iii) the profit or loss of the company, fund or other entity that issues the contract.’
- 238 As the definition of a DPF highlights, policyholder participation rights give the insurer some discretion, but also constrain that discretion. The combination of discretion with constraint makes it difficult to determine whether such rights create a liability for the insurer.

How do participating contracts work?

- 239 For a non-participating contract, an insurer charges a premium to pay for the expected policyholder benefits and compensate it for assuming risk under the contract. For a participating contract, the insurer charges a larger premium. If actual outcomes are in line with the insurer’s expectations, the insurer refunds part or all of the excess premium to participating policyholders. To illustrate, suppose that an insurer issues 1,000 non-participating contracts for which the expected (ie probability-weighted) value[†] of future claims and benefits is CU80 per contract. The actual claims and benefits will turn out higher than CU80

* IFRS 4 defines guaranteed benefits as ‘payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer’.

† To simplify the description, this example ignores the time value of money. A more complete example would refer to the expected **present** value.

for some contracts and lower for others. However, there is a risk that the total claims and benefits will exceed CU80,000 (1,000 times CU80). The insurer might charge, say, CU89 per contract to provide a target expected return of CU9 as compensation for bearing that risk and for servicing the contract.

- 240 Consider now what would happen if the contracts are participating contracts. The insurer might charge, say, CU100 per contract. If actual claims and benefits equal the previously estimated expected value of CU80 per contract, the insurer will pay a dividend of, say, CU13 to each policyholder.* This will leave a margin of CU7 per contract for the insurer. If actual claims and losses are lower than CU80 per contract, the insurer will pay a larger dividend. If actual claims and losses are higher than CU80 per contract, it will pay a smaller dividend. Unless average claims exceed CU93, the insurer can always achieve its target margin of CU7 per contract. The insurer (and, ultimately, the insurer's owners) bears the risk that claims exceed CU93; below that level, the participating policyholders bear the risks. In contrast, the insurer bears all the risks in the non-participating contract. For that reason, the target margin for the participating version of this contract (CU7) is lower than the target margin for the non-participating version (CU9).
- 241 In this example, both the participating and non-participating versions of this contract protect policyholders against financial consequences of insured events by pooling the experience of all policyholders. However, the non-participating contract also protects the policyholder against the risk that aggregate losses of all policyholders as a class are worse than expected. In contrast, the participating contract does not protect policyholders against that risk. Thus, participating contracts limit the aggregate risk borne by the insurer.
- 242 Participating contracts vary greatly in the mechanisms used to share favourable performance with policyholders. Typically, these mechanisms involve the following three steps, which may occur in the same accounting periods or in different periods:
- Step 1: Determine the amount available for distribution (described below as the distributable amount). Typically, participating contracts (or the surrounding legal and regulatory environment) specify the basis for determining the distributable amount. In some instances, the distributable amount is the profit, as determined for general purpose financial reporting, arising from a defined pool of contracts. In other instances, the distributable

* As noted before, this entire example ignores the time value of money.

amount is based on a different formula (for example, a formula that includes all realised investment gains but excludes unrealised investment gains). In some cases, the distributable amount is the profit for the current period. In other cases, it is the cumulative undistributed profit since the inception of the pool of contracts.

- Step 2: Allocate part, or all, of the distributable amount to policyholders as a class (as opposed to the owners of the insurer). In some instances, the contract, law or regulation requires the insurer to allocate at least some of the distributable amount to policyholders as a class. For example, the insurer may be required to allocate at least 90 per cent of the distributable amount to policyholders as a class. In other instances, no minimum allocation is specified. In many instances, insurers allocate more than the required minimum, and there is often a market expectation that they will do so. In some participation systems, no minimum allocation is required, but if any allocation is made to the owners of the insurer, the insurer must allocate at least a specified amount to policyholders at that time. This paper uses the term ‘policyholder surplus’ to describe the cumulative amount allocated to policyholders as a class but not yet distributed to individual policyholders.
- Step 3: Distribute to individual policyholders part, or all, of the policyholder surplus determined in step 2. In some cases, distribution policies are intended to distribute the profit arising from a generation of policyholders to the same generation of policyholders. However, this is not always intended, and may not always be feasible. The distributions may take various forms, such as cash, additions to the level of insurance coverage or additions to surrender values. Various names are used, such as bonus, dividend, allocation, distribution. For ease of discussion the following paragraphs use the term ‘policyholder dividend’.

243 In most cases, insurers have some discretion over steps 2 or 3, or both. However, that discretion is usually subject to some constraints (contractual, legal, supervisory or market).

244 In some cases, insurers have some implicit discretion over step 1. For example, if the distributable amount includes realised gains but not unrealised gains, the insurer can sell investments to change the time when distributable amount arises. Sometimes, the insurer’s only discretion is over step 1: once the gains are realised, the insurer must distribute them to specified policyholders. Sometimes, the insurer has

some discretion over step 1 (timing of asset sales) and step 3 (deciding when to distribute policyholder surplus), but has no discretion over step 2 (because it must add all realised gains, or a specified portion of them, to policyholder surplus).

- 245 Some allocations to policyholder surplus are irrevocable. In other cases, the insurer may revoke the allocation in specified circumstances (eg to avoid insolvency). Similarly, policyholder dividends are often irrevocable, but in some cases the insurer can revoke them in specified circumstances.
- 246 Some policyholder dividends are paid to all policyholders in a specified class whose contracts are then in force. In those cases, part of the profit generated by one generation of policyholders is distributed to future generations of policyholders. A change in the timing of a distribution means that a different generation of policyholders will benefit (although typically the generations overlap). In other cases, insurers are required (or choose) to allocate policyholder surplus among policyholders in a way that reflects the relative contributions from each contract to that surplus (the ‘contribution principle’).

Definition of a liability

- 247 The *Framework* defines a liability as ‘a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.’ For a participating contract, the critical question is whether the insurer has a present obligation to pay policyholder dividends. In this respect, *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* sets an important precedent. *IAS 37* identifies two categories of obligations: legal obligations and constructive obligations. A legal obligation is an obligation that derives from a contract (through its explicit or implicit terms), legislation or other operation of law. *IAS 37* defines a constructive obligation as

an obligation that derives from an entity’s actions where:

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

248 In June 2005 the Board published an exposure draft proposing changes to IAS 37, including a new definition of a constructive obligation as:

a present obligation that arises from an entity's past actions when:

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept particular responsibilities; and
- (b) as a result, the entity has created a valid expectation in those parties that they can reasonably rely on it to discharge those responsibilities.

249 That proposed definition emphasises that a constructive obligation involves an obligation to others. Hence it is not something that an entity can avoid at will or imposes on itself. The proposal does this by specifying that no constructive obligation exists unless the counterparty has a valid expectation that it can reasonably rely on the entity to discharge its responsibilities. Paragraph 15 of the exposure draft gives more guidance:

In the absence of legal enforceability, particular care is required in determining whether an entity has a present obligation that it has little, if any, discretion to avoid settling. In the case of a constructive obligation, this will be the case only if:

- (a) the entity has indicated to other parties that it will accept particular responsibilities;
- (b) the other parties can reasonably expect the entity to perform those responsibilities; and
- (c) the other parties will either benefit from the entity's performance or suffer harm from its non-performance.

250 The Board plans to finalise in 2008 a standard resulting from the exposure draft on IAS 37. In that project, the Board has not yet discussed whether the exposure draft's proposals on constructive obligations require modification.

251 Several factors suggest that in some (perhaps many) cases, a constructive obligation to pay policyholder dividends may arise when an insurer issues a participating contract:

- (a) Contract, marketing literature and other statements typically indicate that the insurer expects to pay a substantial part of the available surplus to policyholders, although the contract does not specify the exact amount or timing and does not establish a precise formula.

- (b) Policyholders pay more for a participating contract because they have a valid expectation that they can reasonably rely on the insurer to pay policyholder dividends. Although they may receive no dividend in some scenarios, that possibility affects the size of the liability, not its existence. Although the insurer has some constrained discretion over the timing and amount of policyholder dividends, that discretion does not negate the existence of the obligation.
 - (c) Policyholders will clearly benefit from policyholder dividends.
- 252 Some jurisdictions use terms such as ‘policyholders’ reasonable expectations’ in a sense similar to the notion of a constructive obligation. Such expectations might arise from various sources, including marketing literature, other public statements and past practice. In some cases, a regulator or the courts might act to enforce policyholders’ reasonable expectations.
- 253 Entities sometimes feel economically compelled to make a payment for competitive reasons, for example to retain or gain market share. Similarly, many entities feel economically compelled to pay dividends to shareholders. However, economic compulsion alone does not create an obligation.

Preliminary views on participating contracts

- 254 In the Board’s preliminary view, the cash flows used in measuring a participating insurance liability should incorporate for each scenario an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date.
- 255 Such an obligation may arise when the insurer becomes a party to the participating contract, but that will depend on the facts of each case. An insurer would need to consider the guidance in IAS 37 to determine whether such an obligation exists.
- 256 In estimating the policyholder dividends payable in a scenario, an insurer would need to consider various possible sources (to the extent that the insurer has a legal or constructive obligation to pay policyholder dividends from those sources):
- (a) policyholder surplus recognised in the financial statements. If the insurer has a legal or constructive obligation to distribute the policyholder surplus in all scenarios, the insurer would recognise

the entire policyholder surplus as a liability. The insurer would also need to consider the effect of any embedded options and guarantees.

- (b) amounts that are recognised in the financial statements but will not be included in policyholder surplus until a future period (for example if distributable amount and policyholder surplus are based on realised gains and exclude gains that are recognised but unrealised).
 - (c) future premiums that are included in the cash flow scenario (because they pass the guaranteed insurability test discussed in chapter 4). For example, if a cash flow scenario includes CU100 of premiums and the insurer estimates that it will pay additional policyholder dividends of CU20 in that scenario because of those premiums, the scenario would include both the premiums and the resulting policyholder dividends.
- 257 The Board's preliminary views apply equally to shareholder-owned insurers and mutuals. They also apply equally to participating insurance contracts and participating investment contracts.
- 258 Because guaranteed benefits and participating benefits have different characteristics, clear disclosure is important. In developing an exposure draft, the Board will consider what disclosure to require about participating liabilities.

Measurement of participating contracts

- 259 The above discussion concentrates on whether an insurer has an obligation to pay policyholder dividends. Brief mention is made below of two measurement issues: the approach to embedded options and guarantees and determining the discount rate. Participating contracts create an asymmetric pay-off that resembles an embedded option or guarantee. For example, consider a contract for which policyholders receive back their original investment plus 90 per cent of any related investment return. The insurer bears the loss if the investment return is negative. For simplicity, the example assumes the contract does not provide other benefits to policyholders (such as death benefits). The total payment to policyholders is the higher of (i) 90 per cent of the fair value of the investments plus 10 per cent of the original investment and (ii) the original investment. This total payment equals the sum of the following three amounts:
- (a) 90 per cent of the fair value of the assets, plus

- (b) 10 per cent of the original amount invested, plus
 - (c) the pay-off from an option to put 90 per cent of the assets for 90 per cent of the original amount invested. To measure the contract at current exit value, the insurer would need to measure this third amount using option pricing techniques that capture both the intrinsic value of that option and its time value on a market-consistent basis.
- 260 The second, related, aspect of measurement relates to the discount rate. Chapter 3 reports the Board's preliminary view that the discount rate should depend on the characteristics of the liability, not the characteristics of the assets held to back those liabilities. For a participating liability, some cash flows from the liability may depend contractually on the cash flows from the underlying assets. For example, if the contract defines distributable amount as investment income less death benefits, distributable amount (and, ultimately, policyholder surplus and policyholder dividends) depends partly on cash flows from assets.
- 261 An insurer would need to measure the asset-dependent cash flows on a basis consistent with the measurement of the underlying assets. If the asset-dependent liability cash flows equal the asset cash flows in all scenarios, the current exit value of the asset-dependent cash flows equals the current exit value of the assets. In more realistic cases, the liability cash flows depend asymmetrically on the asset cash flows because of guarantees or options. In those cases, more sophisticated techniques are needed to reflect the asymmetry on a market-consistent basis.

Universal life contracts

- 262 The American Council of Life Insurers defines universal life insurance as

A type of permanent life insurance that allows you, after your initial payment, to pay premiums at any time, in virtually any amount, subject to certain minimums and maximums. This policy also permits you to reduce or increase the death benefit more easily than under a traditional whole life policy. To increase your death benefit, the insurance company usually requires you to furnish satisfactory evidence of your continued good health.*

* <http://www.acli.org/ACLI/Consumer/Glossary/Default.htm>

- 263 A universal life contract typically operates as follows:
- (a) Premiums are added to a policyholder account.
 - (b) The contract permits the policyholder to vary premiums, within specified limits.
 - (c) The contract provides mortality coverage as long as funds remain in the policyholder account to pay the mortality and other charges. Some contracts contain 'secondary guarantees' that permit mortality coverage to continue even if the policyholder account is exhausted.
 - (d) Within specified limits, the contract may permit the policyholder to increase or decrease the amount of life insurance coverage without a medical examination.
 - (e) Deductions are made from the policyholder account for mortality charges and perhaps for other items, such as administration costs or acquisition costs. The contract may limit the level of mortality or other charges.
 - (f) Interest is added to the policyholder account, based on the account balance. Depending on the contract, this may be:
 - (i) interest determined using a crediting rate set by the insurer, reflecting factors such as the returns on the assets backing the contract(s), market conditions, competitive considerations, expectations established in marketing literature and regulatory requirements. The contract may specify a minimum crediting rate.
 - (ii) the return on a specified pool of assets dedicated to a series of contracts. The contract may specify a minimum crediting rate, for example a return of premiums. The contract may permit the insurer to deduct a periodic investment management fee from the pool of assets.
 - (g) The contract may permit the policyholder to withdraw the account balance. Withdrawals may be subject to surrender charges, and the contract may restrict the timing of withdrawals.
- 264 The following paragraphs discuss two aspects of universal life contracts: crediting rates and future premiums.

Crediting rates

- 265 For some types of participating contract, policyholder benefits reflect returns on a specified pool of assets, although the insurer has some discretion to vary the amount and timing of that participation. The crediting rate mechanism for a universal life contract can have a similar effect, because actual asset returns can affect crediting rates, although they are not the sole determinant. Therefore, some argue that an insurer should account for interest credited to universal life contracts in the same way as for policyholder dividends arising from participating contracts.
- 266 Some may take the view that the insurer has no obligation to credit to policyholder accounts more than the guaranteed minimum. They would measure the liability on that basis. For that measurement, lapse estimates would need to be consistent with a strategy of crediting the contractual minimum and no more.
- 267 However, in the Board's preliminary view, a measurement based solely on the contractually guaranteed minimum crediting rate is unlikely to provide useful information for users. Instead, estimates of crediting rates in each scenario should reflect the estimated rate payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date.

Future cash flows

- 268 Chapter 4 expresses the preliminary view that the measurement of an insurance liability should include premiums that the policyholder must pay to retain guaranteed insurability. For many traditional life insurance contracts, all future premiums specified in the contract would pass that test. However, because universal life contracts give the policyholder considerable freedom to vary the premiums, some premiums for those contracts would probably pass the test but others would probably fail. The Board intends to carry out further research on the operationality and relevance of the guaranteed insurability test for these contracts.

Unit-linked contracts

- 269 For some insurance contracts, some or all policyholder benefits are contractually determined by the price of units in an internal or external investment fund (ie a designated pool of assets held by the insurer or a third party and operated in a way similar to a mutual fund). This paper describes these contracts as **unit-linked contracts**, the benefits that are

determined by the unit prices as **unit-linked benefits**, the pool of assets as **separate account** assets and all of an insurer's other assets as **general account** assets. In some countries, such contracts have other names, for example variable contracts or segregated funds.

270 Unit-linked contracts typically have most or all of the following features:

- (a) The premium received from the policyholder is used to buy units in a fund, in some cases after the insurer has deducted a front-end fee or a bid-ask spread.
- (b) The unit price at any time reflects the fair value of the assets held in the fund, possibly adjusted for a bid-ask spread.
- (c) Charges are deducted from the fund (as a whole) for investment management, administrative and other expenses and tax.
- (d) Other charges are often made to a policyholder's account for insurance coverage (eg a fee for mortality protection), and perhaps also for contract administration and as a means of recovering acquisition costs. These charges are typically determined as a monetary amount, with units cancelled to provide that amount (number of units cancelled equals the monetary amount, divided by the unit price). In some cases, the charges are levied by issuing special subclasses of units that do not pass through all investment performance (eg where 'capital units' are used as a means of recovering acquisition costs).
- (e) Depending on the structure and legal set-up, the assets in the fund may or may not be insulated from the insurer's other activities. If the assets are not insulated, this may be an important difference from most mutual funds. That difference may be relevant in determining whether the insurer should recognise the assets of the fund.
- (f) A unit-linked contract may provide both unit-linked benefits and other non-unit benefits (eg life coverage). This paper deals only with the unit-linked benefits. The general principles being developed in the rest of this project would apply to the non-unit benefits.
- (g) Insurers often provide some guarantees related to the investment performance of unit-linked benefits. There may be a separate explicit fee for the guarantee.

- 271 These contracts give rise to two accounting questions:
- (a) Should the insurer recognise the pool of assets and the related liabilities?
 - (b) In most existing accounting models, the underlying assets are measured at fair value and the same measurement is used for the related part of the liability. What happens if the insurer cannot classify some assets as 'at fair value through profit or loss'?
- 272 This chapter does not address the following topics because other chapters discuss them:
- (a) revenue recognition relating to fees from unit-linked policyholders (see discussion of service margin in chapter 4).
 - (b) treatment of future premiums, including future premiums that are expected to recover acquisition costs (as explained in chapter 4, included in the measurement of the liability to the extent the policyholder would lose guaranteed insurability if the policyholder either stops paying premiums or surrenders the contract).
 - (c) measurement of guarantees related to the investment performance of unit-linked benefits. These would be measured at current exit value (for a unit-linked insurance contract) or fair value (for a unit-linked financial instrument).

Recognition and presentation of separate account assets

- 273 The Board considered three treatments for separate account assets:
- (a) Exclude the separate account assets from the issuer's balance sheet and exclude the related part of the liabilities. The related part of the liabilities is the part that depends directly on the performance of the assets. If the liability includes other parts (eg guarantees of investment performance or additional death benefits), these would be recognised.
 - (b) Include the separate account assets in the issuer's balance sheet as a single line item separate from the issuer's general account assets, and include the entire liability as another line item.
 - (c) Include in the issuer's balance sheet the separate account assets, commingled with the issuer's general account assets, and include the entire liability as another line item.

- 274 The first approach excludes the separate account assets (and the related portion of the liabilities) from the issuer's balance sheet. Arguments for this approach are as follows:
- (a) In substance, the assets are held for policyholders. They derive the direct benefits from the performance of the assets, and bear the investment risk associated with them. The insurer derives only indirect benefits from the assets through investment management fees and through the effect on any performance guarantees given by the insurer.
 - (b) In some cases, the assets are not available to the insurer for general business purposes.
 - (c) This treatment is consistent with how an asset manager accounts for funds it manages.
 - (d) This approach eliminates accounting mismatches that could occur if the unit-linked assets are not measured at fair value through profit or loss (see paragraphs 278–286).
- 275 The second approach includes the separate account assets as a single line item separate from the issuer's general account assets and includes the entire liability as another line item. Arguments for this approach are as follows:
- (a) The insurer controls investment decisions.
 - (b) Excluding part of the insurer's obligation from the insurer's balance sheet is not appropriate if the insurer must satisfy the entire obligation.
 - (c) The single-line presentation is helpful for users because it distinguishes assets for which the policyholders bear all the investment risk from the insurer's other assets.
- 276 The third approach commingles the separate account assets with the issuer's general account assets. Arguments for this approach are as follows:
- (a) The insurer controls investment decisions.
 - (b) Reporting part of the insurer's obligation off balance sheet is not appropriate if the insurer must satisfy the entire obligation.
 - (c) This approach groups all assets with the same characteristics in the same line items.

- 277 The Board has not yet formed a preliminary view on the recognition and presentation of separate account assets. The Board is discussing related issues in its project on consolidation.

Accounting mismatches for unit-linked contracts

- 278 In most countries, insurers measure all assets in unit-linked funds at fair value and measure the unit-linked benefits on a similar basis: if the obligation is to pay benefits equal to 100 units, the benefit is measured at 100 times the current unit price. However, accounting mismatches can arise if some or all of the unit-linked assets:
- (a) cannot be recognised. This might occur if the unit-linked assets include shares or financial liabilities of the issuer itself (treasury shares) or goodwill in operating subsidiaries.
 - (b) are recognised, but cannot be measured at fair value. This might occur if the assets are not financial assets and meet the definition of inventories in IAS 2 *Inventories* ('assets held for sale .. in the ordinary course of business ..'), in which case they are measured at the lower of cost and net realisable value. (Commodity broker-traders may measure their inventories at fair value less costs to sell.)
 - (c) are measured at fair value, but changes in their fair value must be recognised outside profit or loss. This might occur if separate account assets include a building that is rented to the insurer for use in its own operations. The building would be an owner-occupied property within the scope of IAS 16 *Property, Plant and Equipment*.
- 279 The Board would prefer to avoid these mismatches, if all else is equal. The following paragraphs discuss two approaches to eliminating them:
- (a) changing the treatment of some or all separate account assets so that they can be recognised and measured at fair value through profit or loss.
 - (b) adjusting the measurement of unit-linked liabilities for differences between the carrying amount of separate account assets and their fair value.

Recognition and measurement of separate account assets

- 280 Changing the treatment of separate account assets could involve some or all of the following exceptions to normal recognition and measurement requirements:
- (a) extending the fair value option in IAS 39 so that it could be used for all separate account assets, financial or non-financial. This approach would build on a treatment that already exists. It would seem most relevant for owner-occupied property.
 - (b) permitting or requiring insurers to recognise as an asset all separate account assets, even if they do not normally qualify for recognition as an asset. This issue might arise if the separate account assets include treasury shares (which do not meet the definition of an asset from the perspective of the insurer as a whole) or internally generated goodwill in operating subsidiaries (which does not qualify for recognition as an asset under existing IFRSs).
 - (c) for changes in the fair value of owner-occupied property held in a separate account, permitting or requiring insurers to recognise them in the income statement.
- 281 Such exceptions would require the Board to develop a definition of separate account assets, or to find some broader principle on accounting for assets held for other parties.

Measurement of unit-linked liability

- 282 If the insurer cannot (even using all available accounting options) recognise the separate account assets and measure them at fair value, an alternative approach would adjust the carrying amount of the liabilities to exclude the part of the policyholder benefits that depends directly on the difference between the carrying amount of the assets and their fair value. Some believe that such adjustments would be an ad hoc and rule-based override of a general measurement principle (current exit value).
- 283 Others view such adjustments as an application of the current exit value principle, not a modification of it. Because the payouts on the unit-linked liability are directly linked to the fair value of the assets, it is inconceivable that a transfer of the liability could occur without a transfer of the linked assets.

- 284 For example, consider separate account assets that include treasury shares (ie the insurer's own shares) with a fair value of CU50 and other financial instruments with a fair value (and carrying amount) of CU950. For simplicity, assume that the contracts carry no investment guarantees and that the current exit value of the remaining contractual rights and obligations is negligible. A hypothetical transfer of the unit-linked liabilities would involve a transfer of both the assets and the liabilities for a net price of zero. Put differently, the insurer would pay for the transfer of the liabilities by delivering treasury shares with a carrying amount of zero and other assets with a fair value of CU950. Arguably, the amount that most faithfully represents the current exit value of the insurer's obligation is CU950. The obligation to deliver the treasury shares could never cause a loss to the insurer. Indeed, if the insurer sold the treasury shares immediately before the transfer and reinvested the proceeds in other assets, the insurer would still have to deliver a pool of assets with the same fair value (but a different composition). Although that pool of assets would now have a carrying amount of CU1,000, the insurer would not have suffered any economic loss.
- 285 Adjustments to the measurement of unit-linked contracts would not eliminate the accounting mismatch for owner-occupied property. That mismatch arises not from different measurements but from different treatments of changes in carrying amount.

Preliminary view on unit-linked contracts

- 286 The Board would prefer to eliminate accounting mismatches that could arise when separate account assets are not recognised or are not measured at fair value through profit or loss. However, eliminating all of them would create several inconsistencies with other requirements of IFRSs. This could conflict with the Board's objective of setting principle-based standards, or require the Board to find some broader principle on accounting for assets held for other parties. Accordingly, the Board has not yet formed a view on whether it would be appropriate to create such inconsistencies with other requirements of IFRSs. The Board welcomes comments from respondents on this issue.

Index-linked contracts

- 287 In some cases, an insurance liability or financial liability is linked to an index, but the insurer (or other issuer) is not contractually required to hold the underlying assets, although it may choose to do so to hedge the liability. There is an effect on profit or loss if the issuer holds the underlying assets and does not measure them at fair value through profit

or loss. Some argue that the Board should either permit the issuer to measure the underlying assets at fair value through profit or loss, or adjust the measurement of the index-linked liability to reflect the measurement of the assets.

- 288 The Board does not intend to pursue those approaches. In this case, the insurer is not compelled to hold the underlying assets and it could transfer the liability without a simultaneous transfer of the assets. (In this respect, index-linked contracts differ from unit-linked contracts.) Therefore, the carrying amount of the underlying assets (if held) is irrelevant in determining the current exit value of the liability. Moreover, introducing exceptions to normal recognition and measurement criteria for the underlying assets (if held) would create a need for definitions, criteria and perhaps even a new form of hedge accounting.

Summary of preliminary views in this chapter

- 289 The cash flows used in measuring a participating insurance liability should incorporate for each scenario an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date. Such an obligation may often arise when the insurer becomes a party to the participating contract, but that depends on the facts of each case. An insurer would need to consider the guidance in IAS 37 to determine whether such an obligation exists. The Board plans to issue a revised version of IAS 37 in 2008, building on the exposure draft of 2005.
- 290 In estimating the policyholder dividends payable in a scenario, an insurer would need to consider various possible sources (to the extent that the insurer has a legal or constructive obligation to pay policyholder dividends from those sources):
- (a) policyholder surplus that is recognised in the financial statements. If the insurer has a legal or constructive obligation to distribute the policyholder surplus in all scenarios, the insurer would recognise the entire policyholder surplus as a liability. The insurer would also need to consider the effect of any embedded options and guarantees.
 - (b) amounts that are recognised in the financial statements but will not be included in policyholder surplus until a future period (for example if distributable amount is based on realised gains and excludes gains that are recognised but unrealised).

- (c) future premiums that are included in the cash flow scenario (because they pass the guaranteed insurability test discussed in chapter 4). For example, if a scenario includes CU100 of premiums and the insurer estimates that it will pay additional policyholder dividends of CU20 in that scenario because of those premiums, the scenario would include both the premiums and the resulting policyholder dividends.
- 291 These preliminary views apply equally to shareholder-owned insurers and mutuals. They also apply equally to participating insurance contracts and participating investment contracts.
- 292 In measuring a participating liability contract at current exit value, an insurer would:
- (a) use option pricing techniques that capture, on a market-consistent basis, both the intrinsic value and time value of the asymmetric pay-offs resulting from the participation feature.
 - (b) measure asset-dependent cash flows on a basis consistent with the measurement of the underlying assets.
- 293 For universal life contracts, estimates of crediting rates in each scenario should reflect the estimated rate payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date.
- 294 For unit-linked contracts, accounting mismatches could arise if separate account assets are not measured at fair value through profit or loss but the related liability is measured at current exit value. The Board would prefer to eliminate those mismatches, but has not yet formed a preliminary view on whether this is appropriate. Nor has it yet formed a preliminary view on the recognition and presentation of separate account assets.
- 295 For index-linked contracts, the insurer is not compelled to hold the underlying assets and it could transfer the liability without a simultaneous transfer of the assets. In the Board's preliminary view, existing requirements in IFRSs remain appropriate for assets held to back index-linked contracts.

Questions for respondents

Question 16

- (a) For participating contracts, should the cash flows for each scenario incorporate an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date? Why or why not?
- (b) An exposure draft of June 2005 proposed amendments to IAS 37 (see paragraphs 247–253 of this paper). Do those proposals give enough guidance for an insurer to determine when a participating contract gives rise to a legal or constructive obligation to pay policyholder dividends?

Question 17

Should the Board do some or all of the following to eliminate accounting mismatches that could arise for unit-linked contracts? Why or why not?

- (a) Permit or require insurers to recognise treasury shares as an asset if they are held to back a unit-linked liability (even though they do not meet the *Framework's* definition of an asset).
- (b) Permit or require insurers to recognise internally generated goodwill of a subsidiary if the investment in that subsidiary is held to back a unit-linked liability (even though IFRSs prohibit the recognition of internally generated goodwill in all other cases).
- (c) Permit or require insurers to measure assets at fair value through profit or loss if they are held to back a unit-linked liability (even if IFRSs do not permit that treatment for identical assets held for another purpose).
- (d) Exclude from the current exit value of a unit-linked liability any differences between the carrying amount of the assets held to back that liability and their fair value (even though some view this as conflicting with the definition of current exit value).

Chapter 7 Changes in insurance liabilities

- 296 This chapter discusses the following questions:
- (a) Should an insurer present premiums as revenue or as deposit receipts? (paragraphs 297–324)
 - (b) Should the Board require an insurer to present separately on the face of its income statement any specified components of the changes in the carrying amount of insurance liabilities? (paragraphs 325–328)
 - (c) Should an insurer's income statement include all income and expense arising from changes in the carrying amount of its insurance liabilities? (paragraphs 329–335)

Are insurance premiums revenue or deposits?

- 297 The following paragraphs discuss:
- (a) components of an insurance premium (paragraphs 298–300)
 - (b) illustrations of a revenue presentation and a deposit presentation (paragraphs 301–308)
 - (c) a difference between life and non-life presentations (paragraphs 309–311)
 - (d) premiums written (paragraphs 312 and 313)
 - (e) premiums earned (paragraphs 314 and 315)
 - (f) possible approaches (paragraphs 316–322)
 - (g) preliminary view (paragraphs 323 and 324).

Components of an insurance premium

- 298 An insurance premium could be viewed as made up of payments by the policyholder for:
- (a) the expected present value of benefit payments to policyholders:
 - (i) payments to policyholders who incur insured losses (as well as payments for claims handling costs)

- (ii) for some contracts, such as annuities, endowments, some finite reinsurance contracts and some group insurance contracts, repayments to the policyholders who paid the premiums
 - (iii) for participating contracts, policyholder dividends
 - (b) acquisition costs and the expected present value of other expenses
 - (c) margins for bearing risk (risk margin) and, if applicable, providing other services (service margin).
- 299 Some view some or all of the payments described in paragraph 298(a) as, in substance, repayments of deposits. For example:
- (a) A repayment to the policyholder who paid the premium could be viewed as a repayment of a deposit by that policyholder.
 - (b) On a broader view, payments of the expected present value of insured losses could be viewed as a repayment to policyholders, as a group, of the part of their premiums that paid for the expected losses. On this view, policyholders make a collective deposit that is later repaid in aggregate to policyholders, although most policyholders receive no repayment and the amount 'returned' to any one policyholder typically differs from the amount 'deposited' by that policyholder.
 - (c) For a participating contract, an insurer typically expects to return some of the premium to policyholders as benefit payments (if insured events occur) or as a policyholder dividend (if insured events do not occur). If benefit payments are higher, policyholder dividends will tend to be lower, although generally not by exactly the same amount.
 - (d) In the broadest sense, a deposit occurs if the policyholder pays premiums significantly before the coverage period. In many life insurance contracts, significant prepayments in the early years are invested and used to provide coverage in later years.
- 300 For convenience, this chapter describes a contractual feature that results in a repayment to policyholders, either individually or collectively, as a deposit component. This chapter describes the implicit or explicit part of the premium that pays for that feature as a deposit premium. This chapter does not specify whether deposit components should be defined narrowly or broadly.

Illustrations

- 301 The following paragraphs discuss how an insurer might present deposit components. One possible format presents deposit premiums as revenue and presents the resulting repayments as an expense. In the other format, those receipts and payments do not appear in the income statement, because this format presents premiums as a deposit receipt and presents payments to policyholders as a repayment of the deposit.
- 302 Examples 10–15 in appendix G illustrate four formats that present premiums as revenue (examples 10–13) and two formats that present premiums as deposits (examples 14 and 15). To permit easier comparison, all six examples use the same fact pattern. Thus, all six examples show the same profit, but the individual line items differ.
- 303 Examples 10 and 11 show traditional presentations for non-life and life insurance. Example 10 treats premiums initially as a liability (unearned premium). When the premiums are earned, the insurer recognises them as revenue. In example 11, an insurer recognises the premiums as revenue immediately; at the same time, an addition to the liability is recognised as an expense. In all other respects, examples 10 and 11 are identical.
- 304 Examples 12 and 13 are largely the same as examples 10 and 11, but present acquisition costs in a way that is more consistent with the preliminary views expressed in chapter 4. In examples 10 and 11, the insurer treats acquisition costs as an asset and amortises that asset over the term of the contract. In examples 12 and 13, the initial measurement of the insurance liability equals the premium received, less the part of the premium that pays for the acquisition costs, and the insurer recognises acquisition costs as an expense when it incurs them (typically, at inception).
- 305 Examples 14 and 15 illustrate two formats that present premiums as deposits. In a fee presentation (example 14), an insurer recognises revenue when it charges explicit amounts against a policyholder account balance for bearing risk or providing services. In a margin presentation (example 15), an insurer recognises revenue when it is released from risk (and, if applicable, renders other services). The fee presentation reports gross explicit or implicit charges to the policyholder account and gross policyholder benefits and claims. In contrast, the margin presentation reports the net margins generated by the contract.

- 306 US GAAP uses a fee presentation for universal life contracts (contracts with an explicit account balance, explicit charges on that balance and with flexible premiums and/or some non-guaranteed charges). Some users have argued that this presentation provides a useful insight into margins. However, applying it may be difficult and arbitrary for contracts that do not explicitly unbundle charges.
- 307 When life insurers provide information about embedded value, some use a margin presentation to explain changes in embedded value. Similarly, some life insurers have supplemented traditional revenue presentations with a margin analysis (sometimes described as a source of earnings analysis).
- 308 A discussion follows of some details of the revenue and deposit approaches: a difference between life and non-life presentations (paragraphs 309–311), premiums written (paragraphs 312 and 313) and premiums earned (paragraphs 314 and 315).

A difference between life and non-life presentations

- 309 Examples 10 and 11 highlight one, perhaps minor, difference between the traditional non-life and traditional life presentations. The non-life presentation recognises the premium initially as a liability, and later recognises it as revenue over time as it is earned. Conventionally, insurers describe the unearned part as deferred revenue. However, the Board analyses it as a cost-based measure of the insurer's obligation to stand ready to pay valid claims.
- 310 In contrast, the traditional life presentation recognises written premiums as revenue immediately when they are due, rather than later when they are earned. At the same time, the insurer recognises an expense equal to the resulting change in the liability. The net effect on profit is the same as in the traditional non-life presentation, but the line items differ.
- 311 Why does this difference in presentation exist? For a traditional one-year non-life contract, the deposit component is small and it may be reasonable to view most of the premium as a prepayment for a service. For a long-duration life insurance contract, the deposit component is larger and it is more difficult to distinguish the part of the premium that is, in substance, a deposit from the part that is a prepayment for future risk-bearing and other future services.

Premiums written

- 312 As illustrated in example 10, many non-life insurers use a two-stage presentation of premiums. First, they show premiums written during the period. From this, they deduct the change in unearned premiums, to arrive at premiums earned. These items may be defined as follows:
- (a) Premiums written are the premiums that became unconditionally receivable during the period.
 - (b) Unearned premiums are premiums that have been written but for which the insurance coverage period has not yet expired.
 - (c) Premiums earned during a period are premiums for insurance coverage during that period.
- 313 Typically, premiums written and premiums received are almost identical. Thus, the two-stage presentation is almost equivalent to reporting a cash flow on the face of the income statement and then adjusting this with a separate line item that summarises the change in a prepayment received from customers. Entities do not typically use this presentation for other receipts from customers and there is no obvious reason to use it for premium receipts. The logical place to give users information about cash flows is the cash flow statement.

Premiums earned

- 314 If an insurer presents premiums as revenue, it must determine when each part of the premium is earned. For many short-term non-life insurance contracts, a straight-line basis is reasonable, with an adjustment if the coverage varies seasonally (for example, insurance for winter sports). However, it is sometimes difficult to determine when premiums are earned, as in the following examples.
- (a) In some cases, such as for some stop loss contracts, the risk cannot be expressed easily as a simple linear factor. For example, suppose a stop loss contract covers 90 per cent of aggregate losses during 20X1 that exceed CU10 million, up to a maximum payment of CU9 million (ie 90 per cent of aggregate losses in the layer between CU10 million and CU20 million). The premium is, say, CU1.2 million. If aggregate losses at 30 June 20X1 are CU5 million, how much of the premium is earned then?
 - (b) In some cases, the risk fluctuates both up and down over time (eg for some types of guarantee). For example, suppose an equity-linked life insurance contract provides a death benefit equal

to the higher of (i) the account value and (ii) 100 per cent of the amount invested. The insurer charges an explicit or implicit additional premium of CU1,000 for the guarantee. How much of the premium is earned if the account value stands at (A) 130 per cent of the amount invested? (B) 100 per cent of the amount invested? (C) 70 per cent of the amount invested? What if the account value goes down to 70 per cent of the amount invested and then goes back up to 100 per cent, or vice versa?

- (c) In some cases, claims have long tails (ie take a long time to settle). For example, suppose a non-life insurer sells annual contracts, subject to large long-tail claims, some of which are not resolved for ten years. Should the insurer recognise the entire premium as revenue over the one-year term of the contract? This is consistent with the view that the insurer is providing services over the coverage period (pre-claims period). Or should it recognise some of the premium later when it is still bearing risk? This is consistent with the view that the insurer is providing the service of bearing risk throughout the entire period over which it is bearing risk (pre-claims period and claims period).

- 315 In some respects, determining when a premium is earned involves a thought process that the insurer would undertake to apply the preliminary views expressed in chapter 3 (ie estimating the remaining cash flows and the remaining risk margin and service margin). However, in the cases described in paragraph 314(a) and (b), applying the 'earning' notion may be more difficult than quantifying the amount that is appropriate for the remaining exposure.

Possible approaches

- 316 Various approaches could be considered for deposit premiums:
- (a) The same treatment for all contracts:
- (i) Present all premiums (including the deposit premium) for all insurance contracts as revenue, and all payments to, or for, policyholders (including claims handling costs) as an expense (paragraph 317).
 - (ii) Present all premiums for all insurance contracts as deposits, and all claims and expenses as repayments of deposits (paragraph 318).

- (b) Different treatments for different classes of contracts:
 - (i) For insurance contracts that meet specified criteria, present all premiums as deposits. For all other insurance contracts, present all premiums as revenue (paragraph 319).
 - (ii) Permit insurers to choose for each class of insurance contracts between a revenue presentation and a deposit presentation, perhaps subject to some constraints (paragraph 320).
 - (c) Unbundling: Unbundle premiums for all insurance contracts, or some specified insurance contracts, into a deposit receipt and a revenue receipt (paragraphs 321 and 322).
- 317 Presenting all premiums as revenue would be largely consistent with existing practice for many contracts. Moreover, if policyholder dividends are treated as an expense, it would be consistent to treat the related premium as revenue. However, this presentation would be inconsistent with how banks account for deposits received and with how fund managers account for customer funds held.
- 318 Presenting all premiums as deposit receipts would create consistency between a deposit component embedded in an insurance contract and a stand-alone deposit. It would avoid the need to unbundle insurance contracts into a deposit component and an insurance component. It would also make it unnecessary to determine when the premium is earned (paragraphs 314 and 315). However, it would be a significant change from current practice. It would also make it more difficult to derive commonly used performance indicators for non-life contracts such as the claims ratio (claims expense divided by earned premium), expense ratio (expenses divided by earned premium) and combined ratio ([claims expense plus expenses] divided by earned premium). Example 10 in appendix G illustrates those ratios.
- 319 Deposit components are more significant in some contracts than others. For example, significant deposit components may exist in many longer-term insurance contracts and in some large longer-term or customised non-life insurance (or reinsurance) contracts. Therefore, one approach would present premiums as a deposit for those contracts that are likely to contain more significant deposit components, and present premiums for all other insurance contracts as revenue. Within each class of contracts, treating all premiums in the same way would be relatively simple. However, the Board would need to define when an insurer should use the deposit presentation (perhaps life insurance contracts, or

long-duration contracts). The Board has identified no other reason to draw boundaries between different classes of insurance contracts. Boundaries might be difficult to define and arbitrary.

- 320 To avoid specifying a possibly arbitrary boundary between different classes of insurance contract, the Board could permit insurers to choose for each class of insurance contract between a revenue presentation and a deposit presentation, perhaps subject to some constraints. This would let insurers select what they regard as the most appropriate presentation in each case, but could undermine comparability.
- 321 Another way to avoid the disadvantages of possibly arbitrary definitional boundaries is to unbundle all premiums into a deposit receipt and a revenue component. This would provide consistency between stand-alone components and similar components embedded in a larger contract. However, unbundling could be costly to perform, and perhaps arbitrary if there are significant interdependencies between components.
- 322 To minimise the disadvantages of unbundling, the Board could require unbundling only in specified cases when the benefits of unbundling are most likely to exceed the costs. For example, the Board could require an insurer to unbundle any deposit component that is not closely related to the underlying insurance exposure. When the Board assesses whether it should propose unbundling, it will consider responses to the FASB's *Invitation to Comment on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*, published in May 2006 as part of its project on insurance risk transfer. In December 2006, the FASB discussed the comment letters and directed the FASB staff to focus on various topics other than unbundling (bifurcation).

Preliminary view on insurance premiums

- 323 Does it matter whether an insurer treats premiums as revenue or deposits? The Board believes it does. Many insurers emphasise total premium revenue as a headline indicator of the size of their business. Some have expressed concerns that using insurance or reinsurance accounting for significant deposit components distorts changes in performance measures such as combined ratios or the ratio of liabilities to premiums. Moreover, some insurers provide supplementary measures that they view as more comprehensive than the premium revenue reported in their income statements. For example:
- (a) Some life insurers report 'annual premium equivalent'. They often define this as the premium revenue for the year from recurring premium contracts plus 10 per cent of the premium from single

premium contracts. The aim is to provide greater comparability between insurers with different ratios of single premium business to recurring premium business.

- (b) Some life insurers report performance measures that combine (i) premium revenue for insurance contracts with (ii) non-revenue inflows (such as deposit receipts) for products such as mutual funds, long-term savings products and universal life contracts.
- 324 This suggests that insurers, and probably also users, view reported revenue and expense as important. So it would seem important to distinguish revenue from deposits. However, the Board has not yet formed a preliminary view on the treatment of premiums and would welcome input from respondents. In reaching a conclusion, the Board will also consider whether unbundling is appropriate in the balance sheet (see chapter 5). In addition, the Board will consider developments in the FASB's project on insurance risk transfer (see paragraph 322).

Changes in the carrying amount of insurance liabilities

- 325 Should the Board require an insurer to present separately any specified components of the changes in the carrying amount of insurance liabilities? The carrying amount of insurance liabilities can change for various reasons, including:
- (a) income or expense, if any, recognised at the inception of new contracts.
 - (b) cash flows:
 - (i) the receipt of previously expected cash inflows (eg premiums).
 - (ii) the payment of previously expected cash outflows (eg claims and benefits, claims handling costs, other expenses arising from the contracts).
 - (c) expected changes:
 - (i) release of previous risk margins as the insurer is released from risk
 - (ii) release of previous service margins as the insurer provides the services specified in the contract

- (iii) accretion of interest as time passes (sometimes known as ‘unwinding of the discount’).
 - (d) changes in circumstances:
 - (i) changes in discount rates
 - (ii) differences between actual cash flows and previous estimates
 - (iii) changes in estimates of cash flows
 - (iv) changes in the effect of embedded options and guarantees
 - (v) changes in margins because of changes in the quantity of risk or changes in the market price for bearing risk or providing other services.
 - (e) policyholder participation:
 - (i) partly or wholly discretionary
 - (ii) non-discretionary
 - (iii) unit-linking.
 - (f) income or expense arising from reinsurance held (caused by some or all of the same factors as the income and expense from the underlying direct insurance contracts).
 - (g) if applicable, the effects of business combinations and changes in foreign exchange rates.
- 326 Two other items are also closely related to the insurance liability: acquisition costs and the part of the premium that pays the insurer for the acquisition costs. Disclosure of the level of acquisition costs is likely to be important information for users.
- 327 Each item identified in paragraphs 325 and 326 is subject to different drivers and has different implications for users who wish to estimate the amount, timing and uncertainty of an insurer’s future cash flows. Therefore, some argue that it would not be sufficient to include in the income statement a single line item reporting the change in the current exit value of insurance liabilities. They suggest that the Board should require insurers to disaggregate the change in the current exit value of insurance liabilities into line items that have different properties. Others argue that it is not likely to be productive to prescribe the disclosure of particular line items, because different breakdowns may be most informative in different circumstances.

- 328 The Board is considering more broadly how income and expenses should be disaggregated and displayed in projects on the presentation of financial statements and on financial instruments. Therefore, the Board has not yet formed a preliminary view on the presentation of changes in insurance liabilities.

Presentation in profit or loss

- 329 Some suggest that the Board should permit or require an insurer to present outside profit or loss the effects of remeasuring insurance liabilities. They argue that this would be consistent with the treatment of available-for-sale financial assets under IAS 39, and would distinguish longer-term performance from short-term market volatility that might reverse over the long term of many insurance contracts. However, the Board has identified no conceptual or practical reason to introduce such an exclusion from profit or loss. Therefore, the Board's preliminary view is that profit or loss should include all changes in the carrying amount of insurance liabilities.

Shadow accounting

- 330 IFRS 4 permits, but does not require, a practice known as shadow accounting. When an insurer uses shadow accounting, some changes in insurance liabilities are recognised directly in equity, outside profit or loss. Shadow accounting is permitted in some accounting models in which realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of its insurance liabilities. Shadow accounting adds the following two features to those models:
- (a) A recognised but unrealised gain or loss on an asset affects the measurement of the insurance liability in the same way that a realised gain or loss does.
 - (b) If unrealised gains or losses on an asset are recognised directly in equity, the resulting change in the carrying amount of the insurance liability is also recognised in equity.
- 331 In permitting, but not requiring, shadow accounting in IFRS 4, the Board noted the following:
- (a) In principle, realised gains or losses on an insurer's assets should not affect the measurement of its insurance liabilities (unless the gains or losses on the asset change the amounts payable to policyholders). However, it was not feasible to eliminate this feature of some existing models in phase I of this project.

- (b) When an insurer uses shadow accounting, all recognised gains and losses on assets affect the measurement of insurance liabilities in the same way, regardless of whether (i) the gains and losses are realised or unrealised and (ii) unrealised gains and losses are recognised in profit or loss or directly in equity. This is a logical application of the feature described in (a).
 - (c) If an unrealised gain or loss on an asset triggers a shadow accounting adjustment to a liability, shadow accounting recognises that adjustment in the same way as the unrealised gain or loss. The Guidance on Implementing IFRS 4 includes an illustration of shadow accounting (IG Example 4).
 - (d) The Board did not, and still does not, expect the feature described in (a) to survive in phase II. Therefore, phase I should not require insurers to develop systems to apply shadow accounting.
- 332 Chapter 3 summarises the Board’s preliminary view that insurance liabilities should be measured at current exit value. Realised gains or losses on an insurer’s assets do not affect the current exit value of a non-participating insurance liability. Therefore, shadow accounting would no longer be relevant for non-participating insurance liabilities.
- 333 For a participating insurance liability, the carrying amount of the assets may affect payments to policyholders and, hence, the current exit value of the liability. Therefore, some may argue that shadow accounting could still be relevant in phase II for participating contracts if either the insurer chooses not to classify the underlying assets as ‘at fair value through profit or loss’ (paragraph 334), or another standard does not permit that classification (paragraph 335).
- 334 Suppose that the underlying assets are equities. If shadow accounting were permitted, an insurer might prefer to classify the equities as available for sale, rather than as ‘at fair value through profit or loss’. In that case, the insurer would recognise unrealised gains and losses on the equities outside profit or loss, together with policyholders’ interests in those gains or losses. Thus, shareholders’ interests in those gains and losses would be recognised outside profit or loss, just as IAS 39 would permit if the insurer used the available-for-sale classification for equities not linked to a participating contract. However, the Board believes that permitting shadow accounting in this case would reduce transparency. In the Board’s preliminary view, if the policyholder interest is recognised as a liability (rather than a component of equity, see chapter 6), it is more transparent for profit or loss to include all changes in that interest.

- 335 Chapter 6 identifies some accounting mismatches that can arise if unit-linked liabilities are contractually linked to assets that cannot be classified as 'at fair value through profit or loss' (treasury shares, owner-occupied property, investments in subsidiaries). Similar issues arise if participating contracts are contractually linked to those assets. Chapter 6 discusses possible solutions to those mismatches, but presents no preliminary view on that topic.

Summary of preliminary views in this chapter

- 336 In developing an exposure draft, the Board will consider whether an insurer should present premiums as revenue or as deposit receipts, and whether an insurer should present separately on the face of its income statement specified components of the changes in the carrying amount of insurance liabilities. The Board has not yet formed a preliminary view on these topics.
- 337 Profit or loss should include all changes in the carrying amount of insurance liabilities.

Questions for respondents

Question 18

Should an insurer present premiums as revenue or as deposits? Why?

Question 19

Which items of income and expense should an insurer present separately on the face of its income statement? Why?

Question 20

Should the income statement include all income and expense arising from changes in insurance liabilities? Why or why not?