



Project	Insurance Contracts
Topic	Targeted Field Test Results

Introduction

1. This paper summarises the results of the IASB targeted field test carried out between September and December 2009.
2. Staff identify the main issues raised by participants for each topic tested and suggest areas for future board discussion.
3. This paper provides a high-level summary of responses. We do not provide detailed information in this paper for confidentiality reasons. Additional information is available to board members on request.

Objective and scope of the field testing

4. The overall objective of the field testing was to assess whether the proposals in the Insurance Contracts project are capable of being applied rigorously and consistently in practice and to gauge costs and benefits of moving to a new measurement approach.
5. Due to the status of boards' deliberations, we asked questions on specific topics rather than conducting a comprehensive field test on the measurement model as a whole.
6. Sixteen organizations from Europe, USA, Canada, Bermuda, Australia and Japan participated, including life and non-life insurers, one re-insurer and two mutuals.

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

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

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

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7. We sent out seven questionnaires and included background information and recent board decisions. These materials were posted on the IASB public website for wider access. The responses are not available to the public and we assured all participants that the information they submitted would remain confidential.
8. Staff provide the following caveats when interpreting the results:
 - (a) Due to the limited sample size, our findings may not be representative of the insurance sector as a whole.
 - (b) The information is incomplete – we were not able to test all elements of the measurement model in a holistic way.
 - (c) Views expressed by respondents are preliminary and based on tentative board decisions in place at the time the questionnaires were sent out.

Field test findings

Overview

9. Generally, in jurisdictions where statutory or regulatory requirements are broadly similar to the boards' tentative decisions on measurement, participants were more comfortable with the proposals. Some life insurers already use projected future cash flow measurement methods to prepare:
 - (a) their financial statements (Australian and Canadian insurers)
 - (b) supplementary information for capital market users (embedded value (EV)¹ approaches)
 - (c) internal management information on economic value or for risk management and capital allocation.
10. Some participants were more familiar (and comfortable) with the incorporation of a risk margin² through practical experience acquired preparing for the forthcoming EU regulatory requirements under Solvency II.

¹ We also refer to EEV (European Embedded Value) and MCEV (Market Consistent Embedded Value) in this paper.

Staff paper

11. Participants provided quantitative analysis, where requested, to support their conclusions on the impact of using different discount rates and the size of acquisition costs and margins at inception. We did not request, and participants did not volunteer, quantitative information on costs and benefits.
12. When we designed the field test we did not expect all participants to respond to every questionnaire. Participants responded to issues pertinent to them and as a result not all issues had a 100% response rate. The overall response rate was, however, much higher than anticipated.
13. Participants highlighted two areas where they thought that recent tentative decisions made by the boards would have a significant financial impact on their business:
 - (a) acquisition costs (day one losses through immediate expensing)
 - (b) discount rate (day one losses for some types of contract through the use of a risk-free rate).

Some composite insurers (ie insurers that issue both life and non-life contracts) were concerned that the IASB's tentative decision to require the use of an unearned premium approach would prevent them from applying one single presentation model for all insurance liabilities.

Acquisition costs (88% response rate)

14. The boards decided tentatively at their October joint meeting that an insurer should:
 - (a) expense all acquisition costs when incurred
 - (b) not recognise any revenue (or income) to offset those costs incurred.

The questionnaire was distributed prior to this decision and therefore reflected a previous tentative decision by the IASB (but not the FASB) that also expensed acquisition costs as incurred, but in addition recognised

² In more recent staff papers this is referred to as the risk adjustment.

revenue at inception to cover incremental acquisition costs. [We refer to this as the alternative approach to distinguish it from the boards' tentative view reached in October.]

Current practice

15. Most participants, except Canadian and Japanese entities, defer and amortize acquisition costs (both incremental and non-incremental) to the extent that these costs are recoverable from future profits, generally over the life of the contract (for life insurers) or in line with earning the premium over the contract period (for non-life insurers).
16. Canadian GAAP follows a similar principle to the alternative approach. All costs, including acquisition costs, are expensed as incurred and revenue is recognised to offset acquisition costs.
17. Under Japanese GAAP acquisition costs are also expensed as incurred. For traditional single premium life contracts all amounts included in the premium by the insurer to recover acquisition costs are recognised as income at issue. For recurring premium business, day one losses are recognised. For internal management reporting the Zillmerised Reserve model relieves the strain of costs related to new business by recognising day one gains corresponding to assumed acquisition costs.
18. The costs deferred in other jurisdictions vary with and directly relate to the selling and issuance of insurance and reinsurance contracts. They include commissions paid to agents, underwriting expenses and policy issuance costs. Participants confirmed that acquisition costs equal a substantial portion of the first year premiums for recurring business (in some cases they exceed the first year premiums) and a lesser, but still significant portion, of the total premium over the life of the contract. Agent commissions formed the largest component.

Impact of the proposals

19. To assess the impact of the respective proposals, both at transition and going forward, we asked participants to provide financial information based on their 2008 financial statements.

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20. The financial results provided by life insurers illustrated the significant impact of the boards' tentative view. Considering the level of DAC (Deferred Acquisition Costs) balances in financial statements, the effect on transition would be significant, resulting in as much as a 50% decrease in shareholder equity.
21. Participants indicated the impact would be exacerbated (both on transition and going forward) where the insurer is in a high growth cycle and incurring a higher proportion of acquisition costs than an insurer with a more mature, steady state business portfolio (where the write off of acquisition costs would be offset by the release of 'extra' profit on prior year business). They found it counter-intuitive and confusing for users that when new business volumes decline there would be an increase in profit and conversely, when new business volumes grow there would be a decrease in profit.
22. Under the alternative proposal the impact on transition is lower than under the boards' tentative view because only non-incremental costs would impact on shareholder equity. The DAC balance relating to incremental acquisition costs would be adjusted against the residual margin.
23. The ongoing impact on net income under the boards' tentative view would be reasonably significant in some circumstances. The income statement impact would depend on new business volumes and expenses (ie whether the insurer is in a high growth cycle). Under the alternative approach the impact would be much less significant, due to only non-incremental costs being expensed. Some participants provided an estimated impact under this approach. More information is available to Board members on request.

Which approach is most useful?

24. In addition to the impact on shareholder equity on transition, life insurers typically thought that the boards' tentative proposal, by creating a loss at the beginning of the contract, did not provide decision-useful information. They generally supported the alternative approach, although some would have preferred to offset revenue against all acquisition costs (both incremental and non-incremental). They provided the following arguments:

Staff paper

- (a) There is value creation on the sale of a contract and contracts are priced to recover acquisition costs (policies usually contain lapse and/or early termination penalties to recover these costs).
 - (b) The alternative approach acknowledges that the insurer expects the contract as a whole will be positive and it therefore better reflects the business model of insurers and the economics of the business.
 - (c) Premiums are recognised in the same period the costs are incurred, which reduces income statement volatility (ie big day one losses followed by inflated revenue / income in subsequent periods).
 - (d) The inclusion of acquisition costs in the insurance liability cash flows and the day one profit calculation (resulting in the residual margin being net of acquisition costs) is consistent with EEV and Solvency II.
 - (e) The application of Canadian GAAP demonstrates that the alternative approach is workable and produces relevant and reliable information to users of financial statements.
25. Some non-life insurers were indifferent between the two approaches on acquisition costs because contract coverage periods are typically 12 months or less and acquisition costs are recouped more quickly than is the case for most life insurance business.

Practical considerations

26. Under the alternative approach, participants raised a number of practical issues relating to the split between incremental³ and non-incremental costs:

³ That is excluding other direct costs not incremental at the contract level. This is consistent with the definition in paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement* – An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

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- (a) On transition, life insurers will be required to carry out an in-depth analysis of costs (going back years for long term business) included in the DAC balance.
- (b) Without a clear and precise definition the split is judgmental.
- (c) The treatment of costs may differ according to distribution channel. For example, marketing expenses for broker acquired business are included in commissions (incremental) whilst marketing expenses for directly acquired business are direct costs (non-incremental).
- (d) Unit of account issues – it may prove difficult to extract incremental costs at contract level.
- (e) New systems (potentially expensive) are needed to capture and allocate costs.

Discount rate (81% response rate)

- 27. The boards tentatively decided that the measurement of insurance contracts should reflect the time value of money.
- 28. On the discount rate, the IASB Board decided tentatively that:
 - (a) conceptually, the discount rate for insurance liabilities should adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability rather than using a discount rate based on expected returns on actual assets backing those liabilities
 - (b) the standard should not include detailed guidance on how to determine the discount rate.

FASB will discuss the discount rate at a future meeting.

- 29. The questionnaire, which addressed non-participating contracts only, focused on the practical implications of:
 - (a) discounting all cash flows (for both life and non-life insurance contracts)
 - (b) moving to a current rate rather than a 'locked-in' rate at inception

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- (c) moving to a rate that reflects the characteristics of the liability rather than the expected rate of return on assets backing liabilities.
30. Some participants provided quantitative analysis (testing different discount rates) in support of their conclusions.

Current practice

31. Whereas life insurers currently discount insurance liabilities under their existing accounting models, non-life insurers generally do not (Australia is an exception). However, some insurers discount non-life insurance contracts for other reasons, such as for internal management reporting or for specific provisions such as those relating to latent claims (eg asbestos related claims). A variety of discount rates are currently used including:
- (a) current risk-free rates
 - (b) expected yields at inception on investments backing liabilities
 - (c) current portfolio yield from assets held to back liabilities
 - (d) original rate implied in expected cash flows at inception
 - (e) original rates assumed in pricing
 - (f) rate derived from using a replicating portfolio.

Proposal for discounting all insurance contract liabilities

32. Some participants favoured discounting all insurance contract liabilities on the grounds that it improves consistency and values liabilities on an economic basis (and is consistent with the measurement of assets). Some participants discount all insurance liabilities for the Solvency II impact studies and have already implemented new systems and procedures.
33. Some non-life insurers were strongly against discounting because, in their view, its use would impair comparability, transparency and understandability. They argued that:

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- (a) the current approach (ie no discounting) is simple, universally understood by preparers and users and conveys useful operating and performance metrics (loss, expense and combined ratios).
- (b) users find estimates of the ultimate cost of claims when settled more useful than expected current values determined through application of discounting and risk margins (which these respondents viewed as complex and difficult to calculate).

Proposed discount rate

34. Participants were asked which rate they would use under the IASB's proposals. Many participants would apply rates consistent with those included in the guidance for Solvency II impact studies and EV approaches ie:
- (a) a swap curve as a proxy for the risk-free rate in each country, or
 - (b) a government bond rate.
35. One participant advocated the use of a pricing interest rate on the grounds that, in the absence of an active market, the only transaction available to indicate the appropriate discount rate is the initial transaction with the customer.

Liquidity premiums

36. Generally participants used yield curves relevant for the currency and duration of the liability. Some participants adjusted discount rates observed for liquid assets to match the characteristics of the liability (liquidity premium). Participants generally applied such an adjustment to annuity insurance liabilities that are backed by assets held until maturity ('buy and hold').
37. One participant used high quality corporate bond rates as a proxy for a discount rate that took into account the liquidity characteristics of the liability. Other participants calculated an explicit liquidity premium. Various techniques are applied including:
- (a) Covered bonds / matched pairs, where the liquidity premium is observed in a pair of assets, which generate equivalent cash flows and credit risk but have different liquidity.

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- (b) Negative basis trade, where the spread on a corporate bond is compared to the spread of a credit default swap (CDS) for the same issuing entity, same maturity, same seniority and same country. Spreads other than credit spreads are assumed to represent the liquidity premium.
- (c) Structural Merton method, which uses option pricing techniques to calculate a theoretical credit spread that compensates only for credit (default and spread) risk. The difference between the theoretical spread and the actual market spread is taken to equal the liquidity premium.

Losses at inception

- 38. Many participants commented that they would not suffer significant losses at inception if they applied an adjustment for the liquidity characteristics of the liability (liquidity premium) to an observable risk-free rate.
- 39. However, one participant was particularly concerned that use of the risk-free rate would result in significant day one losses and cause severe volatility in earnings. This participant strongly disapproved of a discounting approach that was not linked to the insurer's business model and risk management strategies. They advocated an asset-based approach to the discount rate.
- 40. They believe that the use of a risk-free rate, even if it were adjusted for liquidity characteristics of the liability, would be inconsistent with the characteristics and assumptions used in determining the cash flows of the insurance liability. In their view, the liability should reflect the risk of the assets and investment performance of the assets, as the assets drive the pricing, margins and profit in the estimation of the liability.
- 41. This participant commented that the use of a liquidity premium was not directly observable (insurance liabilities do not 'trade' on active markets, so there is no verifiable reference for the liquidity premium) and not consistently applied. In addition there was a lack of guidance as to how it should be calculated.

Practical considerations

- 42. Participants raised a number of implementation issues:

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- (a) costs of enhancing systems and financial processes to ensure they could support quarterly reporting and track subsequent changes to interest rates
 - (b) costs associated with internal and external (analyst community) education.
 - (c) problems transitioning existing portfolios to the proposed basis if proposals are required to be applied retrospectively.
43. Many participants considered the determination of the discount rate using observable market rates to be relatively straight forward. However, some participants raised the following concerns:
- (a) How to extrapolate rates for contracts that run for 50 years or more and the market is thin.
 - (b) How to determine the liquidity premium in countries where the credit default swap (CDS) market is less developed.
 - (c) Guidance is required for the selection of a discount rate. If the principle is not sufficiently clear in the final standard, it will result in inconsistent application.

Embedded derivatives (69% response rate)

44. Many participants did not have embedded derivatives that were required to be bifurcated under IFRS or local GAAP.
45. One participant supported the separation of embedded derivative features from insurance contracts when the economic risks and characteristics of these features are very different from the economic characteristics of insurance contracts.
46. Another participant did not see any benefit in bifurcating embedded derivatives from insurance contracts as these would already be close to fair value under the current proposed measurement approach. They questioned the usefulness of the information resulting from bifurcation.

Presentation of the performance statement (69% response rate)

47. The questionnaire referred to agenda paper 4B (FASB Memorandum 28B) used at the October 2009 joint meeting, at which staff introduced four different models (traditional non-life, traditional life, fee and margin models)⁴ for presenting the performance statement. No alternative models were suggested by participants.
48. Conceptually, many participants supported one model for all insurance contracts, but questioned whether a ‘one model fits all’ approach is workable. Whether composite insurers are able to apply one model depends on whether the boards require them or permit them to use an unearned premium approach as a proxy for short-duration (non-life) insurance contracts; if the boards require an unearned premium approach, composite insurers would be compelled to use two presentation models.

Traditional non-life presentation

49. Many non-life insurers (and some composite insurers) supported the traditional non-life model for contracts with short-duration risk coverage. Several participants commented that it was the most decision-useful model because it:
- (a) is widely used and understood by insurers, investors, regulators, shareholders, rating agencies and analysts.
 - (b) provides relevant information about the economics of the business by focusing on underwriting income.
 - (c) facilitates the direct computation of key performance ratios (claims, expense and combined).
50. One non-life insurer stated that if there was demand for more detailed margin analysis, this should be provided as additional disclosure, rather than fundamentally changing the current basis of income statement presentation for non-life companies.

⁴ In more recent staff papers these are referred to as the earned premium, written premium, unbundled (fee) and summarised margin presentation models. The expanded margin model has also been added.

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Traditional life presentation

51. The boards tentatively rejected the traditional life model in January since it recognizes revenue on the basis of written premiums rather than as the insurer performs under the contract.
52. One participant commented that the traditional life model does not reflect the underlying measurement model. Its use under Phase II would result in the income statement incorporating premiums, claims and expenses presented on an annual inflow/outflow basis, whilst the profit would be measured by the movement in the year arising from the re-measurement of the insurance liability (projected future cash flow model). This model also did not focus on the main drivers of profit in long term business.

Fee presentation

53. There was little support for the fee approach. Unbundling would result in an arbitrary allocation of premium into revenue and deposit elements. Some participants noted that this does not reflect the way insurers price and manage their business, which would reduce the model's decision-usefulness. Unbundling was considered to be complex and subjective. Participants also believed it would be burdensome and expensive to administer.

Margin presentation

54. Many, but not all, life and composite insurers supported the Margin presentation model because it:
 - (a) enables performance to be presented in a manner that is consistent with the underlying measurement model.
 - (b) identifies the amount the insurer expects to earn as profit and the amount of margin being carried for future risk and uncertainty.
 - (c) enables investors to see clearly the profit generated from the provision of insurance services and investment gains.
 - (d) is consistent with EV reporting.

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- (e) is the one single model appropriate for both life and non-life insurance business, thereby enabling composite insurers to present a consolidated income statement on a consistent basis (assuming they are not required to use the unearned premium approach).
55. One participant believed that the IASB's tentative decision to mandate the unearned premium approach for the pre-claims period of short-term contracts would perpetuate different approaches to both measurement and presentation for life and non-life contracts in Phase II (see also earlier comments in paragraph 48).
56. However, some participants thought that the aggregated presentation in the original Margin presentation model was not decision-useful because under this approach individual components of earnings (premiums earned, fee income, surrender charges, death benefits and claims expenses) would be combined into one number and any additional analysis relegated to disclosures. Another participant thought it was contrary to the disaggregation principle in the *Financial Statement Presentation DP*.

Practical considerations

57. Participants commented on the disruption and cost associated with moving to a different model and education requirements (both internally and externally).

Margins at inception (69% response rate)

58. The boards have tentatively decided that, in principle, the initial recognition of an insurance contract should not result in the recognition of an accounting profit, instead the measurement of the contract liability should include a residual margin. They have also tentatively decided that the risk adjustment (risk margin) should measure the insurer's view of the uncertainty associated with future cash flows.
59. The questionnaire addressed issues relating to the margin (incorporating both residual and risk margins) at inception only: it did not cover subsequent treatment of margins.

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Current practice

60. A majority of participants (both life and non-life insurers) do not use a current measurement approach based on expected probability weighted cash flows and the calculation of explicit risk margins for IFRS or local GAAP reporting:
- (a) Life insurers typically use a deterministic best estimate approach.
 - (b) Non-life insurers use a UPR (Unearned Premium Reserve) approach for the pre-claims portion. Probability weighted cash flows are not typically applied in the post claims reserves; claims and expenses are measured on an 'incurred basis' (actuarial best estimate with an implicit risk margin and loss development tables).
61. A current measurement approach is however applied in:
- (a) Australia where it underpins Margin on Services (MoS) accounting (life insurance contracts) and is used for accounting for outstanding claims liabilities (for non-life insurance contracts).
 - (b) Canada where the Canadian Asset Liability Method (CALM) requires cash flows of the insurance liabilities to be projected.
 - (c) Europe for Solvency II purposes and economic capital models.
 - (d) Europe and Japan for EV (and MCEV).

Magnitude of overall and residual margins

62. Most non-life insurers do not have a separate margin presentation; they currently use combined ratios anticipated at inception to measure expected profitability. In their submissions life insurers provided quantitative information on the magnitude of overall and residual margins (to eliminate positive day one differences) by product line and geographical area. Participants stated that residual margins would be significant but would vary materially according to the treatment of acquisition costs. Some participants provided information both gross and net of acquisition costs.

Explicit risk margins

63. For most non-life insurers applying an explicit margin in the measurement of the post-claims liability is a departure from existing practices that rely on estimates incorporating an implicit (and often unstated) degree of conservatism or prudence.
64. One non-life insurer believed that claims and claims expenses should continue to be measured on an incurred basis, using actuarial best estimates (including implicit risk margins). This participant commented that there were no well defined actuarial estimation methods to derive an explicit risk margin.
65. Participants identified a number of methods for calculating an explicit risk margin under the boards' proposals including:
 - (a) a cost of capital approach⁵ (the preferred choice for participants that are familiar with EV and Solvency II)
 - (b) the Wang transform method
 - (c) a probability of adequacy (PoA) approach for the calculation of outstanding claims.

Practical considerations

66. Some participants identified the need for improved valuation and pricing models, including capabilities for stochastic modelling. One participant mentioned that the complexity and effort in determining probability weighted cash flows using all scenarios under a current measurement approach would be considerable.
67. Another participant expressed concerns about the frequency with which valuations would need to be carried out to reflect changing economic conditions. In turbulent economic times where interest rates and equity price assumptions may change dramatically, this may have a significant impact.

⁵ The cost of capital approach acknowledges that an insurer's ability to sell new business to policyholders depends on holding sufficient capital to enable it to cope with adverse events. Alternatively, it represents the cost of holding the capital that is needed to give policyholders comfort that valid claims will be paid and to comply with regulatory capital requirements.

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68. One participant observed that whilst the estimate of future cash flows is a current estimate, the insurance liability at inception is calibrated to the premium, which is non-current because it is determined using assumed interest rates set on the basis of the expected return the insurer is able to earn at the pricing date.
69. Most participants do not think the calculation of the overall margin at inception is problematic, assuming that it is broadly defined as the premium less discounted expected losses and expenses less incremental acquisition costs.
70. Most, but not all, participants (especially life insurers) expected the residual margin to be significant at inception. These participants commented that the boards' tentative view on acquisition costs would result in an increase in the size of the residual margin (due to calibration to the gross premium without subtracting any acquisition costs). One participant thought the residual margin was in effect grossing up the liability for costs that have already been incurred and paid. This is consistent with responses to the questionnaire on acquisition costs.
71. Even those participants familiar with the calculation of a risk margin commented that modifications to models would be required and that it would result in significant computational costs and present an audit challenge.
72. Some participants thought that the calculation of a risk margin using the cost of capital approach would be complex and time consuming. One questioned what the real cost of capital is and how volatility is assessed where experience is limited and the environment is changing. Another thought moving from a cost of capital approach would involve major costs associated with building a control framework, infrastructure and implementing new processes to support quarterly reporting.
73. Two participants thought that splitting the margin into separate risk and residual margin components would be an arbitrary exercise and would not result in meaningful information.

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Guidance

74. Most participants thought that the draft guidance on cash flows and risk margins accompanying the questionnaire was adequate and that it should remain principles-based in a future standard. The draft guidance was based on the information provided in the DP *Preliminary Views on Insurance Contracts* and the models being considered by the boards at that time (ie the updated IAS 37 model (IASB) and a current fulfilment value (FASB)).

Unearned premium model (56% response rate)

75. The IASB has decided tentatively:
- (a) that an unearned premium (UP) approach would provide decision-useful information about pre-claims liabilities of short-duration insurance contracts.
 - (b) to require rather than permit the use of an unearned premium approach for those liabilities.

The FASB will discuss the unearned premium approach at a future meeting.

Current practice

76. All respondents currently use an UP approach for the pre-claims period of short-duration contracts (non-life insurance), using passage of time or release from risk (many viewed these as equivalent for short-duration contracts) as the driver for release to the income statement. One non-life insurer pointed out that this may not be the case where there is an uneven pattern of insurance risk, for example, with catastrophe risk (eg homeowner insurance during the hurricane season, where the premium is more likely to be earned on the actual period of exposure). Most participants would not expect these drivers to differ under the boards' future proposals.
77. All respondents are required under local GAAP and regulatory requirements to carry out liability adequacy tests (LATs) to ensure that premiums are sufficient to cover liability obligations. For the type of contracts that are expected to qualify

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for the UP approach, participants confirmed that it is unusual for deficiencies to arise.

Require or permit?

78. Participants were asked whether they supported requiring or permitting the UP approach as a proxy for a prospective measurement for the pre-claims period of short-duration (non-life) contracts.
79. Most, largely non-life insurers, favoured **requiring** the use of a UP approach because:
- (a) it ensures consistency and comparability (within the subset of short-duration / non-life insurance contracts).
 - (b) it is universally used and understood by preparers and users.
 - (c) the infrastructure is in place to account for UP.
 - (d) it is impractical to require a prospective measurement approach using probability weighted cash flows and risk margins for non-life contracts during the pre-claims period.
80. As mentioned in paragraph 48, some participants (composite insurers) were concerned that this requirement would prevent them from using the same single model for both life and non-life insurance contracts.
81. Concerns were also raised about the arbitrary nature of a cut-off point (12 months or less) for short-duration contracts that would qualify for the UP approach. One participant commented that many non-life contracts with durations between 1 – 5 years may be very similar in nature and are all suited to the UP approach, irrespective of duration.

Liability Adequacy test (LAT)

82. Participants were asked whether under the UP approach a LAT should be based on the cost test included in the DP *Preliminary Views on Revenue Recognition in Contracts with Customers* or whether a prospective measurement approach should be used. Respondents were divided on this issue. Some thought that

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because the UP approach was a simplification of the current measurement approach, the LAT should not be complex and be based on a cost test, while others thought that it should reflect the measurement basis of the liability, either prospective (current) or cost based (UP).

Policyholder behaviour (37% response rate)

83. In identifying the boundary between existing contracts and new contracts, the boards have tentatively decided that the starting point is to consider whether the insurer can change the pricing or other terms.
84. The questionnaire dealt with recognition (not measurement) issues ie which cash flows relate to the existing contract. It did not address issues related to policyholder participation.
85. Questions focused on constraints on re-pricing and re-underwriting that may suggest that cash flows result from an existing contract (and thereby determine the boundary of the contract). These constraints were included in principles put forward by the International Association of Insurance Supervisors (IAIS) and industry groups. We also requested information on specific insurance product features to assist the project team in writing additional guidance.

Re-pricing and re-underwriting constraints

86. Participants generally thought a test based on the insurer's unrestricted ability to re-underwrite and re-price (or change other terms and conditions of) an individual contract provides a useful principle for defining which cash flows should be included in the measurement of the contractual liability. They did not identify additional constraints. Neither did they think that the two sources (IAIS and industry groups) would lead to different outcomes in practice.
87. The Staff intend to bring this issue back to the boards in March when the principles referred to in this questionnaire will be discussed.

Next steps

88. The activity has highlighted some areas that we plan to bring back to the boards for future discussion, particularly in relation to:
- (a) day one losses that arise from the treatment of acquisition costs
 - (b) day one losses that result from the use of the risk-free rate and whether (and how) liquidity premiums are incorporated
 - (c) the IASB's tentative decision to require the UP approach for short duration contracts which precludes the adoption of a single presentation model for composite insurers.
89. Staff believe that there is value in conducting a more comprehensive field test once the boards' decisions on the measurement approach have been published in an exposure draft (ED). This would achieve the objective of testing:
- (a) the measurement model as a whole
 - (b) topics not included in round one, such as the subsequent measurement of margins (including the release or allocation of the residual margin to the income statement, the accounting treatment of changes in estimates and the re-measurement of the risk adjustment).

Question for the boards

Do you have any questions or comments about the targeted field test staff has conducted so far or are planning during the ED comment period?