



Staff Paper

Project **Insurance contracts**

Topic **Field tests: preliminary report**

What is this paper about?

1. This paper presents the preliminary results from the field tests of the proposals in the IASB's Exposure Draft *Insurance Contracts*.
2. This paper considers the following aspects of the field tests being performed:
 - (a) Population covered
 - (b) Basis of data used by participants
 - (c) Type of feedback received
 - (d) Assumptions and limitations of the tests

This paper is for discussion only and no decisions are requested.

Background

3. Between September and December 2009 the IASB held a first round of targeted field tests. The objective of this round was to assess (a) whether the proposals being developed could be applied consistently in practice; and (b) how the proposed approach would change current practice. The Board considered the results from this test (in agenda paper 14F for the February 2010 Joint IASB/FASB meeting) as it developed the Exposure Draft (ED) *Insurance Contracts*.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB 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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4. Between September 2010 and January 2011 the IASB conducted a second round of field tests aiming at testing the proposals in the ED in order:
 - (a) to understand how the proposed approach would operate in practice;
 - (b) to identify where more detailed implementation guidance may be required;
 - (c) to evaluate the costs and benefits of the proposed approach; and
 - (d) to assess how the proposed approach will help insurers to communicate with users of their financial statements.

Field Test Participants

5. Fifteen insurers agreed to take part into this second round of field test. However, two of the participants could not complete the testing.
6. The entities participating in this round of field tests were selected to keep the same balance in terms of geographical and product type coverage as in the first round. In both the first and the second round, the size of the sample considered is not statistically relevant and therefore it does not allow us to conclude that the responses received are necessarily representative of the positions of the insurance industry in any specific regional area.
7. Participants agreed to be publicly listed on the IASB's public website and we list them in Appendix A. However, the field test results are confidential and we will present any findings in a way that does not allow for the identification of any of the results with any particular participant.

Field test material

8. The field test questionnaire was developed in conjunction with the participants (instructions and questionnaire are attached in Appendix B) and comprises five sections, as follows:

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- (a) General information, aimed at capturing the coverage of the testing in terms of products, level of aggregation, source of data and any limitations applied.
- (b) Test of the measurement model through application of the ED proposal for the building block approach and/or the modified approach. A narrative description of the results was requested.
- (c) Test of the presentation of the statement of comprehensive income.
- (d) Test of the disclosure proposals (optional section).
- (e) Test of specific aspects of the ED, including the definitions of portfolio of insurance contracts and incremental acquisition costs, unbundling criteria, a comparison of composite versus residual margin approaches and transition.

Overview of expected field test output

9. We expected that the results from the field tests would:
- (a) allow us to understand better some of the arguments presented to us in our outreach, as well as in the comment letters.
 - (b) provide supporting material to help our understanding of qualitative arguments from respondents on the ED proposals. For example, information about the size of the impact in retained earnings of setting a nil residual margin on transition date could be a consideration for the boards when they evaluate the merit of the proposals for transition.
 - (c) provide input for the development of board papers on the specific issues addressed in the testing (eg unbundling, acquisition costs, definition of a portfolio).

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Preliminary results

Population covered

10. Field test responses covered both life (*69% of responses*) and non-life (*46% of responses*) insurance lines of business (the count includes the actual product types tested and the total exceeds 100% because some respondents covered both life and non-life; also for the purpose of the count, health insurance has been included in the non-life business). The products being tested can be summarized as follows:
 - (a) Participating and non-participating life insurance contracts, including term-life, whole life, universal life, immediate and deferred annuities, endowments.
 - (b) Non-life insurance, including motor insurance, fire insurance, homeowners insurance, natural disasters insurance, health insurance, managed care, disability and income insurance.
 - (c) Participating investment contracts.
11. Participants tested the ED proposals using either a qualitative or quantitative approach. The qualitative approach consisted mainly of providing comments and suggestions regarding the expected impact of the proposals based on previous experience. Those using a quantitative approach presented numerical evidence supporting their comments and suggestions, mainly based on the following time periods¹:
 - (a) 1/1/2008 – 31/12/2009 (*60% of responses*); or
 - (b) 1/1/2009 – 30/06/2010 (*40% of responses*).
12. All respondents – either individually or as part of an industry group or together with other respondents – also had sent a comment letter on the ED and their field test responses generally cross refer to these letters (Appendix A lists the comment letters sent by each participant).

¹ Some respondents also showed projections of cash flows and estimates of margins run-off for future years.

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13. With the field test, most participants tried to provide supporting evidence for the positions expressed in their comment letters. This might partly explain the fact that some respondents have only addressed selected parts of the questionnaire, and particularly those which were relevant in the context of the comments they had submitted. We recorded the following response rates:
 - (a) General information – (100%)
 - (b) Testing the measurement model – (85%)
 - (c) Testing the presentation proposals – (77%)
 - (d) Testing of the disclosure proposals (optional section) – (38%)
 - (e) Testing specific aspects of the ED – (85%):
 - (i) Definition of a portfolio – (85%)
 - (ii) Acquisition costs – (85%)
 - (iii) Unbundling – (77%)
 - (iv) Composite vs. Residual margin – (62%)
 - (v) Transition – (85%)
14. Participants also considered different units for the testing. In some cases they focused on the product-level and regarded each product as a separate portfolio, in other cases, a legal entity or group level was considered.

Source of data used by participants and key limitations of the tests

15. We asked participants to include in their responses the source of data used as a basis for their testing. This will allow us to better understand the extent of the differences between the ED proposals and each insurer's existing reporting model, and the specific comments that participants made on the proposals.
16. The four US insurers based their responses on both US GAAP and inputs from internal models and statutory reporting systems (31% of total responses). Some other entities – mainly European IFRS filers –based their responses (38% of total

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responses) on inputs from economic evaluation models (Market Consistent Embedded Value and European Embedded Value) and inputs from regulatory frameworks such as Solvency II and the related fifth Quantitative Impact Study – QIS 5. Remaining respondents based their responses on their national GAAP (Canadian, Japanese and Australian) (31% of total responses).

17. The source of data used to prepare the responses also constitutes the main source of limitation for the testing. In fact, in order to facilitate their participation, we encouraged respondents to re-use, where possible, pre-existing data to approximate the requirements in the ED proposals. As a result, the following adjustments were common:
 - (a) The use of net-of-reinsurance cash flows instead of gross cash flows. In some cases, the amount of gross of reinsurance cash flows was approximated based on mathematical formulas.
 - (b) In most cases entities considered cash flow projections from their existing systems. Where those projections did not split between incremental and non-incremental acquisition costs and did not separately identify overhead costs, participants made their own estimates in order to split the acquisition costs and to deduct overheads (eg a certain percentage of ongoing expenses). However, in some cases, for simplicity participants did not split incremental and non-incremental acquisition costs. Some participants decided to loosen the ED criterion for identifying incremental acquisition costs, for example by including all costs broadly associated with acquiring a contract, such as all medical underwriting costs.
 - (c) The estimate of risk adjustments was most frequently based on regulatory requirements or on existing local GAAP techniques. Participants regarded those techniques as being consistent with the risk adjustment principles outlined in the application guidance of the ED, although in some cases they differed from the three techniques prescribed in the ED.

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- (d) Some respondents were not able to determine the amount of diversification effects to be added back to their regulatory-based estimates of the risk adjustment. In fact, these estimates include benefits of diversification between portfolios, at an individual entity level or at a group level.
- (e) Some participants indicated a lack of clarity in some areas of the ED (eg unbundling requirements or the type of costs to include in the estimate of fulfilment cash flows). This, together with the complexity of the ED proposals and time constraints led two respondents to suggest that more time should be given to the industry in order for them to be able to fully assess the practical implications of those proposals.
- (f) Where systems to develop probability-weighted estimate of cash flows were not in place, for simplicity, best estimate cash flows were used as an approximation. This occurred also in those cases where the probability distribution was not symmetric around the mean.
- (g) Proxies for illiquidity adjustments were used due to the lack of generally accepted guidance on these adjustments. For example, two participants considered the illiquidity premium as equal to the difference between the discount rate used for pricing purposes and the risk-free rate when testing both participating and non-participating contracts. Some participants were unable to determine an illiquidity premium and therefore set it equal to zero. Others determined illiquidity premiums using regulatory-based guidance (eg QIS 5) or in the report on liquidity premiums² of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS – now European Insurance and Occupational Pensions Agency, EIOPA).

² CEIOPS, Task Force, Report on the Liquidity Premium, 1 March 2010 available on https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/submissionstotheec/20100303-CEIOPS-Task-Force-Report-on-the-liquidity-premium.pdf.

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Next steps

18. The staff are currently discussing individual field test results with participants through follow-up meetings and conference calls. Following these, staff intend to present further information as appropriate.


Next steps

What further information do you want us to provide in a future field test report (bearing in mind the limitations of our confidentiality agreement)?

Appendix A

Appendix A: List of field test participants

Participant	Comment letter number
Allianz	233
Allstate	137
AMP	168
AXA	242
Aviva	CFO Forum – 46
Dai-ichi Life	LIAJ – 84
Eureko	20
Legal & General	102
Manulife	128
Massmutual	131
Metlife	173
QBE	75
Sompo Japan	GIAJ – 79
Swiss Re	120 (with other entities)
United Health Group	132 (with other entities)

	IASB Insurance Contracts Project	September 2010
	Field Testing Instructions and Questionnaire	

A. Introduction

Thank you for offering to take part in field testing the proposals in the IASB's Exposure Draft (ED) *Insurance Contracts*. Through field testing we aim:

- to understand how the proposed approach would operate in practice;
- to identify where more detailed implementation guidance may be required;
- to evaluate the costs and benefits of the proposed approach;
- to assess how the proposed approach will help insurers to communicate with users of their financial statements.

During this round of field testing, the IASB intends to test the overall accounting model for insurance contracts proposed in the ED. A previous round tested targeted areas to support the Board in the development of the ED.

We appreciate that this will be a busy period for many of you. Other ongoing commitments may limit your resources for field testing. Therefore, we recognise that you may need to tailor your efforts to limited areas in the light of your available resources and to restrain the scope of your testing activities within a selected area of your business. If, at any stage, you have concerns about whether you can complete the testing within the required time and at an acceptable cost, please feel free to discuss with us whether there are ways to modify the scope or nature of the testing while still achieving our objectives.

Confidentiality

We will treat your field test results in the strictest confidence. At the same time, the IASB and the FASB intend to continue to consider jointly issues arising from the ED. Therefore, we intend to share field test information with the FASB project team and involve them in at least some conference calls that will be held with participants. We will not release any data from individual participants to parties other than staff and Board members of the IASB and FASB.

Any information we release publicly about the results of the field tests will not enable readers to identify data about individual participants.

If you have any questions on the IASB field testing activity please contact:

Alessandro d'Eri, aderi@ifrs.org, Tel: +44 (0)20 7246 6495

B. Instructions

These instructions are intended to assist participants in determining the scope of their field testing activities. Although we expect participants to choose the most appropriate format to report their findings, we hope these instructions will assist them in preparing their submissions to the IASB.

Timing

We would like all participants to complete Part I - General Information by 14 October 2010. We would like participants to complete their testing and report their findings to us by 30 November (the comment deadline for the exposure draft). We would also welcome ongoing status updates and early submission of partial results. However, we realise that this timetable is tight. Therefore, if you cannot complete the testing by that date, we would be very grateful if you could give us some preliminary findings by the end of November 2010 and your final findings by the end of December 2010.

Field Test Design and Structure

We would like participants to test the proposals in the ED regarding:

- (a) the measurement model for insurance contracts;
- (b) the presentation of the statement of comprehensive income; and
- (c) the related disclosure requirements (testing of the disclosure requirements is included in the measurement section and in a separate optional section).

The section marked as “optional” is an integral part of the Questionnaire, but we suggest participants to address it only when the other sections have been wholly or partially completed.

The field test questionnaire is structured as follows:

- (a) **Part I – General information.** This section asks for information that will allow us to understand what the coverage of the field test is in terms, for example, of type of

business and products that participants have offered to test. We also request information about how the participant intends to apply the ED proposals in completing this field test exercise. This information will provide us with a preliminary overview of the field testing activities so that, where needed, we can clarify any misunderstandings or tweak the extent of the testing before it takes place. As noted above, we ask that this section is submitted by 14 October.

- (b) **Part II – Testing the measurement model.** We aim to test both the main measurement model and the modified approach for short-duration contracts. However, participants may focus on one of those two approaches.
- (c) **Part III – Testing the proposals for the presentation of the statement of comprehensive income.**
- (d) **Part IV – Testing disclosure requirements (optional).**
- (e) **Part V – Testing other aspects of the accounting for insurance contracts.** This section asks questions on specific aspects of the accounting for insurance contracts, although we have not repeated the questions included in the Invitation to Comment on the ED. We presume you will consider these questions anyway in preparing your response to the ED. In particular, we ask for information comparing the risk adjustment plus residual margin approach (proposed in the ED) and the composite margin approach (favoured by the FASB). We appreciate that this may require you to perform some additional work, but we believe this exercise will help the IASB and the FASB assess which of these two approaches they should adopt.

The extent of testing would depend on your time and other resources constraints. The testing should, ideally, **cover two reporting periods** and involve **one or more selected areas of your business** (it may involve, for example, testing complete books of business or single products, selected product lines or business units, etc). Testing may include both direct insurance and related reinsurance contracts. We also suggest that participants test how the proposals would apply in interim reports (for contracts whose duration is 6 months or less, at least on a quarterly basis).

In the measurement and presentation sections, we would like participants to extend the test to both the insurance liability and the related assets. This would include information on the measurement of reinsurance assets as well as financial and non-financial assets related to the

insurance liabilities being tested. For this purpose, we would ask participants to apply IFRS 9 to account for the financial assets and other IFRSs to account for non-financial assets. Testing both the liability and the asset side will better highlight the existence – as well as the impact – of any accounting and economic mismatches that may arise.

Field Test Output

We would like to receive your feedback on each of the items being tested in a narrative form supported, if appropriate and feasible, by quantitative information.

In order to limit the resources required for the field test, you may want to consider incorporating in your testing information that is already available to you or readily obtainable. If your testing is subject to limitations that may result from the re-use of existing information for the purpose of this field test, or from “simplifying” a real-life environment to better fit the case-study approach, please indicate clearly any such “simplifying hypotheses” in Part I of the Questionnaire. In addition, if you subsequently need to make further simplifications after the submission of Part I of the Questionnaire, please send us details together with your results.

Cost-benefit considerations

In general, information regarding the impact of the proposals will assist the Board in better assessing cost-benefit considerations as well as determining the relative importance of selected proposals. Therefore, we will ask you to provide an assessment of both benefits and costs (both one-time and ongoing) of implementing the proposals.

Benefits associated with a new standard may include:

- better information for users;
- increased credibility and representational faithfulness of financial reporting, which is critical to investor confidence; and
- improved financial processes resulting in better pricing, risk and capital management.

Costs may include:

- costs to understand the new requirements (eg training costs); and
- costs to collect, process and analyse new information (eg costs associated with systems changes).

We recognise that it may be easier to quantify costs rather than benefits, although we think there is value in trying to identify both.

C. Questionnaire

Part I – General information

(If more than one block of business is tested, please provide general information for each of them.)

- (f) Test objective (main measurement model and/or modified measurement model for short-duration contracts).
- (g) Object of testing (Group of entities – Single entity – Line of business – Single product).
- (h) Type of business (Life – Non-Life).
- (i) Overview of product(s) (Main features, key profit drivers, key risks).
- (j) Indication of the source of data and of any limitations (including any simplifying hypotheses) adopted for this field test together with a high-level description of how the participant intends to test the ED proposals.
- (k) Existing accounting policies under which the product(s) being tested are accounted for (please indicate the specific set of accounting standards you apply, eg IFRSs, US GAAP, etc).
- (l) If participating contracts are tested, please provide details on the participating features.

Part II – Testing the measurement model (paragraphs 16-66, B34-B110 and BC45-BC155)

Considering (a selected part of) your business:

- (a) Please apply the proposed measurement model to account for insurance liabilities and related reinsurance assets. Please use the relevant IFRS to measure the financial and non-financial assets related to the business being tested (please apply IFRS 9 for financial assets).
- (b) Description of the assumptions and the techniques used for the calculation of the following:
 - i. present value of fulfilment cash flows (including description of any incremental acquisition costs);
 - ii. the risk adjustment; and
 - iii. the discount rate (with separate indication of the calculation of the liquidity premium).
- (c) Description of the run off of the margins and indication of changes in estimates and experience adjustments.
- (d) Please highlight any issues you have experienced in applying the measurement approach with the different levels of aggregation provided for the different building blocks (eg allocation of the risk adjustment to the cohort level of aggregation for the residual margin).
- (e) Please prepare a reconciliation of movements in contract balances (roll forward) in accordance with paragraphs 86-89 of the ED (providing separate indication of the amount of non-incremental acquisition costs).
- (f) In accordance with par. 90 (b) (i) of the ED, please provide information regarding the confidence level to which the risk adjustment corresponds.
- (g) If you apply the modified approach in paragraphs 54-60 of the ED, please ensure your test includes the application of paragraph 60 (onerous contracts).
- (h) A list of the key assumptions made.
- (i) Narrative description of the output, analysis and interpretation of results.
- (j) Implementation considerations:
 - i. Cost / benefit considerations.
 - ii. Overall practicability and feasibility issues.

- iii. Potential implications for systems and / or financial reporting processes.
 - iv. Does this ED supply the right amount of guidance, or is the guidance too much or too little?
 - v. Do you think that any of the proposals impose unnecessary burdens? If so, what do you propose to simplify these proposals while achieving the same objective?
- (k) Any other considerations from the participant.

Part III – Testing the presentation of the statement of comprehensive income (paragraphs 72-78 and BC157-BC187)

Please prepare a statement of comprehensive income in accordance with paragraphs 72-78 of the Exposure Draft. The statement of comprehensive income should also include income and expenses arising from the financial and non-financial assets related to the business being tested. (Please apply IFRSs to account for these assets and, in particular, IFRS 9 to account for financial assets.)

Part IV – Testing disclosure requirements (optional) (paragraphs 79-97, BC242 and BC243)

- (a) In addition to the information requested in Part II paragraphs (e) and (f), please prepare disclosures to comply with the proposed requirements in paragraphs 79-97 in the ED, to supplement the information on the measurement approach.
- We recognise that you may not have time to prepare these disclosures to the high standard required for published financial statements. If you are willing to share the disclosures with us, we would be interested in seeing them, but we realise this may be difficult if the disclosures contain information that is not in the public domain. Our primary objective in asking you to prepare the disclosures is to identify any practical issues and to gain an impression of whether the disclosures are complete, clear and necessary.*
- (b) Do you think that the information presented on the face of financial statements and the information conveyed in the disclosure provide together a complete set of information for users of financial statements? Do you think non-GAAP measures

would need to supplement these disclosures? If so, which non-GAAP measures would you insert?

- (c) What is the impact of the application of the proposed disclosure requirements in quantitative (eg additional work hours needed) and qualitative (eg clarity of information) terms as compared to current practice?

Part V – Testing specific issues

- (a) *Definition of a portfolio of insurance contracts*

How did you apply the definition of a portfolio of insurance contracts provided in the ED?

- (b) *Definition of incremental acquisition costs*

- i. Do you have any practical issues in distinguishing between incremental acquisition costs as determined at a contract level and non-incremental acquisition costs?
- ii. What kinds of non-incremental acquisition costs did you incur?

- (c) *Unbundling*

- i. Do you have any practical issues in applying the unbundling principle?
- ii. What type of products do you think would qualify for unbundling according to the principle proposed in the ED?
- iii. For products that you unbundled, how significant were the effects of unbundling?
- iv. For products that you did not unbundle, would unbundling have been more appropriate?

- (d) *Composite vs. Residual margin*

- i. What is the impact of the application of the composite margin approach at initial recognition to (a selected part of) your business, compared to the application of a residual margin approach? In other words, if you identified any loss at initial recognition under the residual margin approach, how much of that loss was due to the risk adjustment?

- ii. Considering subsequent measurement, how does the run off of the margins under the two approaches (composite vs. residual margins) differ when applied to (a selected part of) your business?

(e) *Transition*

- i. What is the impact of the application of the proposed transitional requirements for (a selected part of) your business?
- ii. Would you be able to apply a fully retrospective transitional approach? If so, please explain how you would implement it.
- iii. Do you see any issues in the application of the proposed disclosure requirements on transition?