Invitation to Comment

ITC 13
May 2007

Request for Comment on IASB Discussion Paper *Preliminary Views on Insurance Contracts*

Prepared by the
Australian Accounting Standards Board

Australian Government

Australian Accounting Standards Board

Commenting on this Invitation to Comment

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 26 October 2007. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 16 November 2007. Comments should be addressed to:

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A copy of all non-confidential submissions to the AASB will be placed on public record on the AASB website: www.aasb.com.au and forwarded to the IASB.

Obtaining a Copy of this Invitation to Comment

This Invitation to Comment is available on the AASB website: www.aasb.com.au.

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PREFACE

Purpose of this Invitation to Comment

The purpose of this Invitation to Comment is to invite comments from Australian constituents on the International Accounting Standards Board's (IASB's) Discussion Paper *Preliminary Views on Insurance Contracts*. In Australia, insurance contracts are currently treated under AASB 4 *Insurance Contracts*, AASB 1023 *General Insurance Contracts* and AASB 1038 *Life Insurance Contracts*.

The Discussion Paper (DP) was published by the IASB on 14 May 2007.

Structure of this Invitation to Comment

The AASB has decided to reproduce the DP without amendment as part of this Invitation to Comment. To assist constituents in their assessment of the IASB's preliminary views, this Preface provides some background information to the insurance project, a summary of the key proposals and indicates particular areas of the financial reporting of insurance contracts that could be impacted in Australia.

The Appendix to this AASB Preface provides a high-level comparison of the IASB's proposals with existing Australian requirements.

Background to the IASB's Insurance Project

This DP presents the preliminary views of the IASB on the main components of an accounting model for insurance contracts. The IASB has formed these views during phase II of its project on insurance contracts.

Phase II will result in an insurance standard that addresses the recognition, measurement and disclosure requirements for all insurance contracts. In line with the AASB's policy of adopting International Financial Reporting Standards (IFRSs), the new international standard for insurance contracts would form the basis for an Australian accounting standard that would replace the existing insurance standards AASB 4, AASB 1023 and AASB 1038.

Phase I was completed in 2004 and resulted in IFRS 4 *Insurance Contracts*, a temporary standard that permits a wide variety of national accounting practices for insurance contracts. Following the publication of IFRS 4, the AASB published AASB 4 and updated AASB 1023 and AASB 1038.

The US Financial Accounting Standards Board (FASB) plans to issue an Invitation to Comment containing this DP and 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.

The IASB has indicated that an Exposure Draft will take at least 18 months from the publication of its DP, and a final standard at least another 12 months after that.

Key Proposals

Summary of Key Proposals

- The DP does not distinguish between general insurance contracts and life insurance contracts; both will be measured using the same measurement model.

- The DP has not reconsidered the definition of an insurance contract introduced by IFRS 4. The IASB expects to reconsider this in developing the Exposure Draft.

- The DP proposes a current exit value model to measure insurance liabilities and reinsurance assets. The Current exit value of an insurance liability is 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 measured using three building blocks: estimates of future cash flows, current market discount rates, and risk and service margins. For short duration contracts, an unearned premium measurement, combined with a liability adequacy test, may be an appropriate approximation of the current exit value.

- Risk margins are determined for a portfolio of insurance contracts that are subject to broadly similar risks and are managed together as a single portfolio (risk margins do not allow for diversification between portfolios).

- Future premiums under existing contracts that the policyholder must pay to retain guaranteed insurability are recognised as an asset that need not be separated from the related insurance liability.

Current Exit Value Model

The IASB'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; 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).

An informative, concise name for a measurement assembled using the three building blocks is 'current exit value', 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.

The IASB's preliminary view is that current exit value is the most relevant and reliable measurement objective for all insurance contracts. For many short duration contracts, unearned premium may often be a reasonable approximation of current exit value, but 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.

Discount rates

Some existing accounting approaches for measuring insurance liabilities use a discount rate based on the expected returns on the assets actually held. However, the IASB 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 market prices for cash flows whose characteristics match those of the insurance liability, in terms of, for example, timing, currency and liquidity. The IASB does not intend to develop detailed guidance on how to achieve that objective.

Risk margins

The IASB's preliminary view is that 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. 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.

The IASB 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.

Several IASB members believe the risk margin should be calibrated to the observed price for the transaction with the policyholder and, in consequence, that an insurer would never recognise a profit at inception. However, a majority of IASB members 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 if it took over the insurer's contractual rights and obligations.

Diversification benefits

The IASB notes that current exit value should be independent of the entity that holds the asset or liability; hence, risk margins should not reflect the benefits of diversification between portfolios and negative correlation between portfolios.

The IASB's preliminary view is that 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.

Credit characteristics of insurance liabilities

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. The IASB note that in practice, such effects are not expected to be significant.

Future Premiums

The IASB's preliminary view is that 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, at a price that is contractually constrained.

The insurer should recognise that asset, and measure it in the same way as the related insurance liability (that is, 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 would not separate that asset from the liability for recognition, measurement or presentation.

Some IASB members disagree with the preliminary view on future premiums expressed above. They 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. Some of them believe that the criterion of guaranteed insurability is open to inconsistent application and abuse. 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. These IASB members also consider that because an insurance liability and a customer relationship have different characteristics, an insurer should always present these items separately, even if part of the customer relationship relates to policyholder exercise of an option within an existing contract.

Acquisition Costs

The IASB's preliminary view is that an insurer should recognise acquisition costs as an expense when it incurs them.

Unbundling

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 independent, the phase II standard should apply to the insurance component and IAS 39 *Financial Instruments: Recognition and Measurement* should apply to the deposit component; and

(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 under IAS 39.

Participating Contracts

The IASB's preliminary view is that the cash flows used in measuring a participating insurance liability should incorporate for each scenario an unbiased estimate of the policyholder dividends that the insurer will pay in that scenario as a result of 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 will depend on the specific facts of each case. An insurer would need to consider IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether such an obligation exists.

Other Issues

Assets held by Insurers

The IASB does not intend to change existing IFRSs for assets held by insurers. As a result there will continue to be some assets held by insurers, which are viewed as backing insurance contracts, which will not be able to be measured at fair value through profit and loss as the existing IFRSs do not allow measurement at fair value through profit or loss for all types of assets. The IASB does not intend to specifically permit or require insurers to use the fair value option for all assets viewed as backing insurance liabilities.

For unit-linked contracts, the IASB 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, the IASB has not yet formed a view on whether this would be appropriate.

Investment Contracts

Appendix B of the DP summarises the differences between the treatment of insurance contracts under the proposed current exit value model and the treatment of investment contracts under IAS 39. The IASB has stated that, in principle, it would prefer to eliminate these differences. However, the IASB has not yet assessed whether that would be feasible.

Presentation of Premiums and Changes in Insurance Liabilities

The IASB's preliminary view is that the income statement should include all changes in the carrying amount of insurance liabilities. However, the IASB 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 any specified components of the changes in the carrying amount of insurance liabilities in developing an Exposure Draft.

Roadside Assistance Contracts

IFRS 4 introduced the following definition of an insurance contract:

> "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".

IFRS 4 states that roadside assistance contracts could meet the definition of an insurance contract. However, roadside assistance organisations have argued that their contracts should not be treated under an insurance standard as, in their opinion, they do not transfer significant insurance risk.

Phase I of the IASB's insurance project was not intended to significantly change existing practice; it was intended to eliminate significant weaknesses. In updating AASB 1023, the AASB agreed that roadside assistance organisations should be subject to the limited improvements under AASB 4 rather than full insurance accounting under AASB 1023. Accordingly, roadside assistance contracts, and other fixed-fee service contracts that meet the definition of an insurance contract, are currently treated under AASB 4.

The DP has not reconsidered the definition of an insurance contract. The IASB expects to reconsider this in developing the Exposure Draft. If the definition continues to capture roadside assistance contracts, these contracts will have to be measured using the current exit value model proposed. Entities that issue other fixed-fee service contracts that meet the definition of an insurance contract will also be subject to this significant change in accounting treatment.

Health Insurance Contracts

The proposed accounting requirements in the DP may have a significant impact on the treatment of health insurance contracts. Prior to phase I of the insurance project, health insurance contracts were not required to comply with either AASB 1023 or AASB 1038. However, with the promulgation of the definition of an insurance contract under IFRS 4, health insurance contracts were brought within the scope of the insurance standards.

The DP proposes that insurance liabilities be measured at current exit value, which is 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. Under a typical general insurance contract, contractual rights and obligations exist over a fixed period of indemnity, usually a year. Under a typical life insurance contract, the contractual rights and obligations extend over many years and they are considered long-term contracts. The life insurer cannot refuse renewal during the contract term and is constrained contractually in amending premiums and benefits.

Health insurance contracts can be seen as long-term contracts in that there is no fixed indemnity period and the insurer cannot refuse renewal. However, unlike life insurance contracts, the health insurer is able to re-price the contract (subject to government approval) and change the benefits. A key issue is whether the health insurer is seen as contractually constrained by the fact that government approval must be sought before premiums can be increased.

Health insurance contracts are currently treated under AASB 1023. Guidance issued by the Australian Health Insurance Association notes that the period of indemnity is considered to be governed by the date paid to, and, for the purposes of the liability adequacy test, health insurers consider cash flows to the date of the next price review.

Under the DP's proposals, it is not clear whether health insurance contracts would effectively be treated as long-term contracts with a requirement to project expected cash flows over a number of years, or whether they would be treated in the same way as general insurance contracts with a fixed indemnity period. If they are to be treated as long-term contracts, this would be a significant change in accounting for health insurance contracts.

Due Process

The AASB will prepare a submission on the DP. The AASB will consult with Australian constituents as part of this submission process in the following ways:

- convening roundtable discussions of the issues raised by the DP in June 2007, with the participation of IASB members and staff;
- considering all submissions received in response to this Invitation to Comment; and
- liaising with its Insurance Project Advisory Panel.

Request for Comments

Comments are invited on all matters in the DP. Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 26 October 2007. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 16 November 2007. The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major features of the DP. The AASB regards both supportive and critical comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
Insurance Liability *AASB 1023 requires a deferral and matching model. Under this model there are different requirements for pre-claims liabilities (represented by the unearned premium reserve) and incurred claims liabilities. The DP does not distinguish between pre-claims liabilities and incurred claims liabilities. Life insurance claims tend to be settled very quickly after notification and hence incurred claims are not a significant component of total life insurance liabilities.*			
Which liability cash flows are included in the liability measurement?	**AASB 1023** *Incurred claims liabilities* Unbiased estimate of expected future cash flows. *Pre-claims liabilities* Measurement at original transaction price or cost.	Explicit, unbiased, market consistent, probability-weighted current estimate of contractual cash flows.	**AASB 1023** The DP does not distinguish between incurred claims liabilities and pre-claims liabilities, both are measured prospectively. The liability adequacy test in AASB 1023 requires a prospective measurement of future expected cash flows in determining the adequacy of the pre-claims liability. APRA requires prospective measurement of incurred claims and pre-claims liabilities. The DP requires market consistent measurement. This may impact on the determination of servicing costs. It is unclear at this stage whether this DP proposal would have a significant practical or financial impact.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
	AASB 1038 Unbiased estimate of expected future cash flows.		**AASB 1038** The DP requires market consistent measurement. AASB 1038 only requires market parameters to be market consistent. This may impact on the determination of servicing costs. It is unclear at this stage whether the DP proposal would have a significant practical or financial impact. The DP makes specific reference to *contractual* cash flows – this could impact the recognition of participating liabilities. See further discussion below.
How are future premiums under existing contracts treated?	**AASB 1023** Future premiums are not typical for general insurance contracts.	Where future premiums provide the policyholder with guaranteed insurability they are included in the measurement of the insurance liability.	**AASB 1023** This may impact on health insurance contracts currently treated under AASB 1023.
	AASB 1038 Expected future premiums are included in the measurement of the liability.		**AASB 1038** There may be some life insurance contracts where expected future premiums will not meet the guaranteed insurability test and cannot be recognised in the liability measurement. This may lead to "losses" that would be expected to be subsequently reversed.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
What are the liability adequacy test (LAT) requirements?	**AASB 1023** *Incurred claims liabilities* LAT is not required as measurement is based on current values. *Pre-claims liabilities* A LAT is required. LAT requires an estimate of the present value of expected future cash flows plus a risk margin. This estimate is compared to the unearned premium liability less acquisition costs. Test is performed at a portfolio level. Any deficiency is recognised in the income statement.	Not required as measurement is based on current values.	**AASB 1023** For pre-claims liabilities this would be a significant change that reflects the different measurement models.
	AASB 1038 Liability adequacy test requires an estimate of the present value of expected future cash flows. Test is performed at the level of groups of related products. Once the planned margin is eliminated any further deficiency is recognised in the income statement.		**AASB 1038** Difference that reflects the different measurement models. A LAT is required in AASB 1038 because the financial effects of changes in assumptions are not always immediately reflected in the income statement. The financial effects are "absorbed" by the planned margin and once the margin is exhausted any additional liability required is recognised in the income statement.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
What are the discount rate requirements?	**AASB 1023** *Incurred claims liabilities* A risk-free rate is required. The incurred claims liability is discounted for the time value of money using risk-free discount rates that are based on current observable, objective rates that relate to the nature, structure and term of the future obligations. *Pre-claims liabilities* No requirement, liability is at cost. Could be argued that there is an implicit discount rate in the pricing of the contract. LAT requires a risk-free rate.	A risk-free rate is required. 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 backing those liabilities. Therefore, the discount rate should be consistent with observable market prices for cash flows whose characteristics match those of the insurance liability, in terms of, for example, timing, currency and liquidity.	**AASB 1023** Consistent with the DP for incurred claims liabilities. For pre-claims liabilities the difference reflects different measurement models.
	AASB 1038 A risk-free rate is required. Life insurance liabilities are discounted for the time value of money using risk-free discount rates that are based on current observable, objective rates that relate to the nature, structure and term of the future obligations.		**AASB 1038** Consistent with DP.

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Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
What is the objective of the risk margin?	**AASB 1023** *Incurred claims liabilities* Risk margin reflects inherent uncertainty in the central estimate. *Pre-claims liabilities* No requirement, liability is at original transaction price or cost. Could be argued that there is an implicit risk margin in the pricing of the contract. LAT requires a risk margin that reflects inherent uncertainty in the central estimate.	To convey decision-useful information to users about the uncertainty associated with future cash flows. The risk margin is compensation for bearing risk that market participants would require.	**AASB 1023** Different objectives.
	AASB 1038 Objective is to achieve recognition of profit over the life of the contract as service is provided.		**AASB 1038** Different objectives.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
What are the risk margin requirements?	**AASB 1023** *Incurred claims liabilities* Liability should include a risk margin which reflects the inherent uncertainty in the central estimate. *Pre-claims liabilities* No requirement, liability at original transaction price or cost. Could be argued there is an implicit risk margin in the pricing of the contract. LAT requires inclusion of a risk margin in estimating future cash flows to reflect inherent uncertainty in the central estimate.	Liability should include an explicit and unbiased estimate of the margin market participants would require for bearing risk.	**AASB 1023** For pre-claims liabilities difference reflects different measurement models. The DP requires a market value margin. It is unclear at this stage whether this would have a significant practical or financial impact.
	AASB 1038 Planned margin is calibrated to original price of the transaction to achieve no gain at inception. In practice, this generally means there is an implicit risk margin; however, there is no requirement to recognise one. AASB 1038 requires planned margin to be recognised as a liability and released as revenue as services are provided.		**AASB 1038** Life insurers typically price their products to include a risk margin. However, any implicit risk margin would be entity-specific rather than a market value margin. The DP proposes an explicit market-consistent risk margin to be included in the expected cash flows. It is unclear at this stage whether this would have a significant practical or financial impact.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
Does the risk margin reflect diversification benefits?	**AASB 1023** *Incurred claims liabilities* Risk margin is applied to net liability of the entity. Insurers may (and generally do) recognise diversification benefits across the entity; these are subject to disclosure requirements. *Pre-claims liabilities* No requirement, liability at original transaction price or cost. Could be argued there is implicit allowance for diversification benefits in the pricing of some insurers' contracts.	Risk margins 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 allow for diversification between portfolios.	**AASB 1023** For incurred claims liabilities the DP proposes a different level of aggregation for determining risk margins. AASB 1023 allows insurers to recognise diversification benefits across the entity. The DP proposals do not. This proposal could have a significant financial impact as it could lead to an increase in claims liabilities.
	AASB 1038 AASB 1038 does not specifically require risk margins. LAT is performed at the level of groups of related products.		**AASB 1038** No comment.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
What are the service margin requirements?	**AASB 1023** *Incurred claims liabilities* Not required. *Pre-claims liabilities* No requirement, liability at original transaction price or cost. Could be argued there is an implicit service margin in the pricing of the contract. However, any implicit service margin would be entity-specific rather than a market-consistent.	Explicit and unbiased estimate of service margin market participants would require for providing other services.	**AASB 1023** Service margins are a new requirement. Not likely to be significant for general insurance contracts.
	AASB 1038 Planned margin is calibrated to original price of the transaction to achieve no gain at inception. In practice this means there may be an implicit service margin; however, this is not a requirement.		**AASB 1038** Life insurance contracts typically involve significant provision of investment services. Life insurers may price their products to include an implicit service margin. However, any implicit service margin would be entity-specific rather than market-consistent. The DP proposals would require an explicit market-consistent service margin to be included in expected cash flows. It is unclear at this stage whether this would have a significant practical or financial impact.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
What are the requirements in relation to the credit characteristics of the insurance liability?	**AASB 1023** *Incurred claims liabilities* Liability measurement does not reflect credit characteristics. *Pre-claims liabilities* No requirement, liability at original transaction price or cost. Arguable whether or not the original transaction price or cost reflects credit characteristics.	The current exit value of a liability reflects its credit characteristics.	**AASB 1023** Unclear whether this would have a significant practical impact. Unlikely to have a significant financial impact in Australia.
	AASB 1038 Liability measurement does not reflect credit characteristics.		**AASB 1038** Unclear whether this would have a significant practical impact. Unlikely to have a significant financial impact in Australia.
Which cash flows are used in measuring a participating insurance liability?	**AASB 1023** General insurance contracts in Australia do not typically include participating features and AASB 1023 does not therefore have requirements in relation to participating liabilities.	Only participating liabilities that satisfy a legal or constructive obligation are recognised as a liability. In all other cases recognition is as equity.	**AASB 1023** No comment.
	AASB 1038 Participating benefits are recognised as a liability and measured using an unbiased estimate of the expected present value of future cash flows. Recognition is consistent with life insurer's obligations under the *Life Insurance Act*.		**AASB 1038** It is possible that not all participating benefits currently recognised as liabilities in Australia would meet the definition of a legal or constructive obligation. In particular, Australian entities with overseas participating business may need to assess the implications of these proposals.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
What are the unbundling requirements?	**AASB 1023** General insurance contracts do not typically include a deposit component. However, any deposit component that can be measured separately should be unbundled. The unbundled deposit component is treated under AASB 139.	Insurance components and deposit components treated 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 independent, the phase II standard should apply to the insurance component and IAS 39 should apply to the deposit component; and (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 under IAS 39.	**AASB 1023** No comment.
	AASB 1038 Unbundling of deposit component required where the deposit component can be measured separately. The unbundled deposit component is treated under AASB 139. The deposit component may give rise to both a financial instrument element and a managed services element. The managed services element (equivalent to a service component) is treated under AASB 118.		**AASB 1038** Where components are interdependent but can be measured separately on a basis that is not arbitrary AASB 1038 requires unbundling (the deposit component treated under AASB 139 and the insurance component under AASB 1038). The DP proposes a different form of "unbundling" in such instances: 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 under IAS 39. The DP does not propose unbundling of any service component. It is unclear at this stage whether the unbundling proposals would have a significant practical or financial impact.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
Income and Expenses			
Is profit on inception recognised?	**AASB 1023** No – any "profit" included in the unearned premium liability and released in accordance with the pattern of risk.	Yes	**AASB 1023** The IASB is divided on this issue. Seven members support recognising profit on inception, six members do not. This has driven the choice of measurement models. Those who support profit on inception favour the proposed current exit value model. Those who do not support profit on inception favour a current entry value model, where the margin is calibrated to the observed transaction price such that there is no profit on inception. Such a model is closer to the model required by AASB 1038.
	AASB 1038 No – planned margin is calibrated to original price of the transaction to achieve no gain at inception. Planned margin is released as revenue as services are provided.		**AASB 1038** See above.
Are losses at inception permitted?	**AASB 1023** Yes – via the LAT	Yes	**AASB 1023** No comment.
	AASB 1038 Yes – via the LAT		**AASB 1038** No comment.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	**AASB 1023 Requirements** **AASB 1038 Requirements**	**DP Proposals**	**Comments AASB 1023** **Comments AASB 1038**
How are premiums presented?	**AASB 1023** Premiums are presented as revenue when earned. **AASB 1038** Premiums are unbundled where the deposit component can be measured separately. The insurance component is presented as revenue in the income statement and the deposit component is recognised in the balance sheet as a deposit.	Deposit components of insurance contracts that are required to be unbundled are treated under IAS 39 and hence would be presented as a deposit (although the DP does not explicitly state this). For all remaining premiums, after the discussion paper stage, the IASB will discuss whether these remaining premiums are to be presented: • as revenue; • as deposits; or • as a combination of revenue and deposits.	**AASB 1023** There is potential for a significant change in presentation. **AASB 1038** There is potential for a significant change in presentation.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
How is revenue recognised?	**AASB 1023** Premium is reflected as a liability on inception and subsequently recognised as revenue in the income statement in accordance with the pattern of risk. Risk margin is "earned" or released as insurer is released from risk.	Future premiums that meet the guaranteed insurability test are effectively reflected in full, from inception, as part of the insurance liability. Risk margin is "earned" or released as insurer is released from risk.	**AASB 1023** Significant difference that reflects the different measurement models.
	AASB 1038 Premiums reflected in full at inception either as an insurance liability (the whole premium where no unbundling has taken place, or the insurance component only where unbundling has taken place) or as a deposit (deposit component where unbundled). Where premiums are to be presented as revenue they are recognised in the income statement when received. Planned margin is released as revenue as services are provided.		**AASB 1038** No comment.

APPENDIX: COMPARISON OF THE IASB'S PRELIMINARY VIEWS AND EXISTING AASB REQUIREMENTS

Issue	AASB 1023 Requirements AASB 1038 Requirements	DP Proposals	Comments AASB 1023 Comments AASB 1038
How are acquisition costs recognised?	**AASB 1023** Deferred and recognised as assets. Amortised in accordance with the pattern of risk. **AASB 1038** Recognised as expense when incurred. Included in future cash flows in determination of planned margin.	Recognised as expense when incurred.	**AASB 1023** Significant change that reflects different measurement models. **AASB 1038** No comment.

DISCUSSION PAPER

Preliminary Views on Insurance Contracts

Part 1: Invitation to Comment and main text

Comments to be received by 16 November 2007

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.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

The IASB, the International Accounting Standards Committee Foundation (IASCF), the authors and the publishers do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

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PART 2

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 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*,[§] 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 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.

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

[†] http://gnaie.net

[‡] http://gnaie.net

[§] http://www.iaisweb.org/060601__Second_Liabilities_Paper_final.pdf

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).

(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

[*] 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.

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.

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.[*]

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)

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

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.

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.

(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

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[*] 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.

[†] 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.

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 avoiding 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		
Purpose of the margin	*Shock absorber*	*Compensation*
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

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.

b Arguably, favourable changes in estimates may affect profit if they reverse previous adverse changes.

c Unless the quantity of risk has not increased since inception.

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 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

[*] 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.

[†] 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

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 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

	Implementation A	*Implementation B*
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
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 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

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

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.

(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.

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

(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.

[*] http://cfoforum.nl/eev.html

(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.

(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.

(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

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

[†] The claims ratio is incurred claims divided by earned premiums.

[‡] The combined ratio is (incurred claims plus expenses) divided by earned premiums.

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 a discussion paper in 2007 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?

(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 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*).

[*] 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.

(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

Balance sheet end of X1	*A exclude all future premiums*	*B unhealthy only (with lapse of unhealthy)*	*C unhealthy only (no lapse of unhealthy)*	*D healthy and unhealthy*
	CU000	*CU000*	*CU000*	*CU000*
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	758	(581)	(595)	–

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 modifying significantly 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

[*] 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.

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 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.

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

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

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).

(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

* 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).

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.

(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.

* 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.

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.

(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

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

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.[†]

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)

[*] IFRS 4, paragraph 14(c)

[†] IFRS 4, paragraph 14(d)

(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 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.

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

(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.

(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.

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* IAS 18, paragraphs 20–28

† 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.

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.

(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.'

[*] 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'.

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 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 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

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

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

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 percent 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.[*]

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.

[*] http://www.acli.org/ACLI/Consumer/Glossary/Default.htm

(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?

DISCUSSION PAPER

Preliminary Views on Insurance Contracts

Part 2: Appendices

Comments to be received by 16 November 2007

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.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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Part 2: Appendices

Appendix A
Questions for respondents

Set out below is a list of all questions posed in this paper. Responses 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.

Respondents need not comment on all of the questions and are encouraged to comment on any additional issues.

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.

Chapter 2

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

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?

(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

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 modifying significantly 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

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 the 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

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

Question 18

Should an insurer present premiums as revenue or as deposits? Why or why not?

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?

Other matters

Question 21

Do you have other comments on this paper?

Appendix B
Comparison with IAS 39

Many insurers issue some contracts that are within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* because they do not transfer significant insurance risk. The following table gives a high level summary of 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. The table includes references to relevant paragraphs of this paper.

Item	*Requirements of IAS 39 and IAS 18*	*Board's preliminary views on insurance contracts*	*Para*
1	**Initial measurement, and acquisition costs**		31–119
	At initial recognition, a financial liability is measured at its fair value:	Insurance contracts would be measured initially at current exit value.	
	• less directly attributable transaction costs, if the liability will be measured subsequently at amortised cost.	An insurer would recognise transaction costs (acquisition costs) as an expense when it incurs them.	161–166
	• without deducting transaction costs, if the liability will be classified subsequently as 'at fair value through profit or loss' (ie if it will be measured at fair value, and all changes in its fair value will be recognised in profit or loss).		
2	**Gain or loss at inception**		83–86
	The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. Thus, no profit or loss arises at inception if the fair value of the instrument at that date equals the transaction price.	A profit or loss could arise at inception if the pricing is out of line with what market participants require. If an insurer identifies an apparently significant profit or loss at inception, it would need to check for errors or omissions.	
3	**Subsequent measurement**		31–119
	The following are classified as 'at fair value through profit or loss':	Insurance contracts would be measured at current exit value.	
	• derivative financial liabilities	The Board is not yet in a position to determine whether fair value and current exit value are the same. However, the Board has not identified significant differences between them.	104
	• other financial liabilities if the fair value option is available and used.		
	All other financial liabilities are measured at amortised cost. Embedded derivatives are		

	separated and classified as 'at fair value through profit or loss', unless they are closely related to the host contract.		
4	**Surrender value floor and policyholder behaviour** The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. This surrender value floor applies contract by contract, not on a portfolio basis.	In general, the surrender value of an insurance contract does not establish a lower limit for the current exit value. However, the current exit value cannot be negative (ie an asset), unless that asset is recoverable from future premiums that the policyholder must pay to retain guaranteed insurability. The measurement of an insurance liability includes the risk-adjusted expected present value of future premiums that pass the guaranteed insurability test.[a]	121–160
5	**Unit of account** The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. The recoverability of origination costs relating to investment management services may be assessed on a portfolio basis.	Risk margins: • would be determined for a portfolio of insurance contracts that are subject to broadly similar risks and managed together as a single portfolio. • would not reflect benefits, if any, of diversification between portfolios and negative correlation between portfolios.	183–202
6	**Presentation of premiums** Proceeds received from the customer are deposits. Therefore, they are not recognised as revenue, and repayments to customer are not recognised as an expense.	The Board has not yet formed a preliminary view on whether premiums would be treated as deposits or as revenue.	297–324
7	**Separation of investment management component** Some contracts involve both the origination of one or more financial instruments and the provision of investment management services. An example is a long-term monthly saving contract linked to the management of a pool of financial assets. The provider distinguishes the financial liability from the right to provide investment management services. This affects the treatment of origination costs and service fee revenue.	If an insurance contract contains both an insurance component and a deposit component, the insurer should treat it as follows: • 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. • 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.	220–228

		Consequently, the insurance component would be measured as the difference between the measurement of the whole contract and the measurement of the deposit component. • 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.	
7(a)	**Investment management component – origination costs** 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 • it is probable that they will be recovered (on a portfolio basis). An incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity's contractual right to benefit from providing investment management services. The entity amortises that asset as the entity recognises the related revenue.	The measurement of the liability would include all future premiums that pass the guaranteed insurability test, including the part of those premiums from which the insurer expects to recover acquisition costs (both incremental and non-incremental). An insurer would 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.	121–160 161–166
7(b)	**Service fee revenue** Fees charged for managing investments are recognised as revenue as the services are provided. Fees received in advance are treated as unearned revenue.	Current exit value would include an explicit and unbiased estimate of the margin that market participants require for providing services. Subsequently, as the insurer provides services, the service margin reduces and the insurer recognises income. That income would be the same as the implicit or explicit fee provided by the contract, unless market participants would require a higher or lower service margin for the same services. The Board has not yet decided whether an insurer should split premium receipts into a revenue part and a deposit part for presentation in the income statement.	87–89 88(e) 297–324

a As described in chapter 4, the Board views these premiums as arising from a customer relationship, not as part of its contractual rights. However, an insurer would measure that part of the customer relationship in the same way as the insurance liability and present them together.

Appendix C
Other relevant IASB projects

C1 This appendix 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. Many of the projects are joint projects with the US Financial Accounting Standards Board (FASB).

Conceptual framework

C2 The IASB and FASB are working on a joint project to improve and achieve convergence of their conceptual frameworks. Comments follow on the four active phases of that project:

- For phase A, the boards released in July 2006 a discussion paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*. The boards have begun their review of responses to the discussion paper.
- Phase B addresses the definition of elements and the criteria for their recognition in financial statements. In the IASB's existing framework, the elements are assets, liabilities, equity, income and expense. The boards expect to release a discussion paper in early 2008.
- Phase C will deal with measurement. The existing conceptual frameworks of the IASB and FASB give little guidance on this subject. The boards conducted public round tables on measurement in early 2007. The first part of phase C will develop common language to describe various measurement bases. Later parts of this phase will develop criteria to assess which base or bases should be used, and when.
- Phase D addresses the reporting entity. The boards expect to publish a discussion paper in 2007.

Revenue recognition

C3 The Board and the FASB are conducting a joint project to develop concepts for revenue recognition and a general standard based on those concepts. For the IASB, the general standard would replace IAS 11 *Construction Contracts* and IAS 18 *Revenue*. The boards plan to publish in late 2007 a discussion paper exploring two models for revenue recognition:

- a fair value model. This would measure contractual performance obligations at the price the entity would have to pay an unrelated party to assume legal responsibility for performing the remaining obligations.
- a customer consideration model. This would measure performance obligations by allocating consideration receivable from the customer.

C4 Each model has support from several members of both boards.

Fair value measurements

C5 The objective of the IASB's project on fair value measurements is to simplify IFRSs and improve the quality of fair value information included in financial reports. The project will not introduce new measurements at fair value. In November 2006 the Board published a discussion paper *Fair Value Measurements*, for comment by May 2007. The paper seeks views on whether the IASB should develop a concise definition of fair value and a single source of guidance for all fair value measurements required by IFRSs. The starting point for the Board's discussions was a recent US standard, SFAS 157 *Fair Value Measurements*.

C6 Some important features of SFAS 157 are the following:

(a) Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

(b) A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.

(c) Market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are:

(i) independent of the reporting entity; ie they are not related parties.

(ii) knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary.

(iii) able to transact for the asset or liability.

(iv) willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so.

(d) Fair value is based on the assumptions that market participants would use in pricing the asset or liability.

(e) Valuation techniques used to measure fair value should maximise the use of observable inputs and minimise the use of unobservable inputs. Observable inputs reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. Unobservable inputs reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

(f) In many cases, the fair value of an asset or liability at initial recognition (an exit price) equals the price paid or received (an entry price), but there is no presumption that they are equal.

C7 The IASB has not yet reached final conclusions on the definitions of fair value for IFRSs (in the FVM project) and current exit value (in the project on insurance contracts). Therefore, the IASB cannot yet determine whether these two notions are the same. The IASB has not identified significant differences between them.

Revisions to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

C8 In June 2005 the Board published an exposure draft proposing revisions to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The Board is reviewing the responses to the exposure draft and expects to finalise a standard in 2008. Insurance contracts are not within the scope of IAS 37. However, developments in this project could set precedents for the treatment of insurance contracts in two areas:

(a) the definition of a constructive obligation

(b) clarifications to the measurement guidance.

Liabilities and equity

C9 The FASB has taken the lead on this project to date, which aims to develop a comprehensive standard of accounting and reporting for financial instruments with characteristics of equity, liabilities or both, and assets. The FASB intends to publish a preliminary views document in 2007. The IASB intends to publish that document in an IASB discussion document. The project may be relevant for the treatment of participating insurance contracts.

Financial statement presentation

C10 The aim of this joint FASB/IASB project is to establish a common, high quality standard for presentation of information in the financial statements, including the classification and display of line items and the aggregation of line items into subtotals and totals. The boards are conducting this project in three phases:

- Phase A defines what constitutes a complete set of financial statements and deals with requirements to present comparative information. In March 2006, the IASB published its phase A exposure draft of proposed Amendments to IAS 1 Presentation of Financial Statements: *A Revised Presentation.* The comment period ended in July 2006 and the IASB began its phase A redeliberations in December 2006. The FASB did not publish a separate exposure draft on Phase A and intends to expose its phase A proposals along with its phase B proposals.

- Phase B addresses the more fundamental issues for presentation of information on the face of the financial statements. The boards plan to publish a discussion paper on phase B in the fourth quarter of 2007.

- Phase C will address presentation and display of interim financial information in US GAAP. The IASB may reconsider the requirements in IAS 34 *Interim Financial Reporting*.

Financial instruments

C11 In 2005 the IASB and FASB established the following three explicit long-term objectives to simplify and improve financial reporting requirements for financial instruments, if technical and practical hurdles can be overcome:

(a) To require all financial instruments to be measured at fair value with realised and unrealised gains and losses recognised in the period in which they occur. Even if all the technical and practical problems are resolved, the boards do not expect to be in a position to require fair value measurement of all financial instruments for several years. The issues that the boards must resolve include: (i) which items should be subject to the requirement, (ii) how to estimate fair value for financial instruments that are not traded in active markets or are traded in government-controlled markets, and (iii) what information to present about past changes in fair value and exposures to future changes in market factors. The boards are working toward resolving some of these issues.

(b) To simplify or eliminate the need for special hedge accounting requirements.

(c) To develop a new standard for the derecognition of financial instruments.

C12 The boards agreed to work toward those long-term objectives while retaining the ability to work either jointly or separately (if necessary) on shorter-term objectives that are consistent with the long-term objectives.

C13 Neither board has added projects reflecting these three objectives to its active agenda because the boards must first address difficult technical and practical issues that are likely to take time to resolve. The boards are addressing some of those issues in active projects. The boards plan to publish a due process document in late 2007 addressing the first two objectives (measurement and hedge accounting).

C14 The staff is also working on a research paper on derecognition to be published as a due process document. That work is in the early stages, and the boards have not yet set a timetable for the document.

Appendix D
Issues not covered in this Discussion Paper

This paper does not address the topics discussed below. The Board expects that an exposure draft will address them, unless the comments below indicate otherwise.

Subject	*Comments*
Scope of standard	The Board will consider in due course whether the scope exclusions in paragraph 4 of IFRS 4 are still appropriate.
Definition of insurance contract	The staff does not expect to recommend major changes to IFRS 4's definition of an insurance contract.
Catastrophe and equalisation reserves	This topic was debated extensively in IASC's *Issues Paper* and *Draft Statement of Principles* (DSOP) and during the development of IFRS 4 (see paragraphs BC87–BC93 of the Basis for Conclusions on IFRS 4). There is no realistic possibility that the Board could conclude that these items are liabilities. The Board does not expect to review the treatment of these items again.
Separate funds	Sometimes, assets are held in separate funds to back specific pools of insurance contracts (particularly, but not exclusively, for participating contracts or unit-linked contracts). The Board will consider in due course whether an insurer should recognise these assets, and the related portion of the liabilities. Starting points for the discussion will be: • the definitions of, and recognition criteria for, assets and liabilities in the *Framework* and the project on the conceptual framework. • the project on consolidation and special purpose entities. • discussion of separate account assets in paragraphs 269-286. • chapter 11 of the DSOP.
Securitisations and other innovative transaction forms, often known as alternative risk transfer (ART)	The Board will assess in due course whether ART transactions pose specific accounting problems.
Deferred tax	The DSOP proposed that an entity whose primary business is issuing insurance contracts should use discounting in measuring its deferred tax assets and deferred tax liabilities. However, the Board decided tentatively in February 2002 not to consider in this project whether discounting is relevant for deferred taxes.
Interim reporting	The Board will assess in due course whether there are any specific interim reporting issues for insurance contracts.
Presentation and disclosure	The Board does not expect to develop significant changes to the high level disclosure requirements in IFRS 4, although some consequential amendments may be needed. The Implementation Guidance may need refinement if different information is available and because insurers will have experience with the disclosure principles in IFRS 4.
Measurement by policyholders	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 items of property, plant and

	equipment. In February 2002, the Board decided tentatively to create the following simplified measurement model for policyholders, based on paragraph 9.6 of the DSOP: (a) prepaid insurance premiums at amortised cost. (b) any readily identifiable investment component at fair value. (c) virtually certain reimbursements of expenditure required to settle a recognised provision at the present value of the reimbursement, but not more than the amount of the recognised provision (as in IAS 37). (d) valid claims for an insured event that has already occurred at the present value of the expected future receipts under the claim. If it is not virtually certain that the insurer will accept the claim, the claim is a contingent asset and would, under IAS 37, not be recognised. The Board will review this tentative conclusion in due course. Paragraphs 206–210 of this paper note that a risk margin increases the current exit value of a reinsurance asset. Similar reasoning may be relevant for a policyholder's insurance asset.
Transition and effective date. Consequential amendments to other IFRSs	To be considered at the exposure draft stage.

Appendix E
Estimates of future cash flows

E1 This appendix is a preliminary draft of guidance on estimating the amount, timing and uncertainty of the future cash flows. The guidance applies to all forms of insurance liability (eg life and non-life, direct insurance and reinsurance).

Overall principle

E2 In estimating the current exit value of insurance liabilities, an insurer should develop estimates of cash flows that:

(a) are explicit.

(b) are as consistent as possible with observable market prices.

(c) incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations.

(d) are current, in other words, they correspond to conditions at the end of the reporting period.

(e) exclude entity-specific cash flows. Cash flows are entity-specific if they would not arise for other entities holding an identical obligation.

E3 The rest of this appendix deals with:

(a) uncertainty and the expected present value approach (paragraphs E4–E8)

(b) consistency with current market prices (paragraphs E9–E14)

(c) source of estimates (paragraph E15)

(d) using current estimates (paragraphs E16–E18)

(e) future events (paragraphs E19–E23)

(f) which cash flows? (paragraphs E24–E26)

(g) entity-specific cash flows (paragraphs E27 and E28).

Uncertainty and the expected present value approach

E4 The starting point for an estimate of current exit value is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome, to derive an expected present value.

E5 Thus, the aim is not to develop a single 'best' estimate of future cash flows, but to identify all possible scenarios and make unbiased estimates of the probability of each scenario.

E6 In some cases, relatively simple modelling may give an answer within a tolerable range of precision, without the need for a large number of detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and respond in a highly non-linear fashion to changes in economic conditions, for example if the cash flows reflect a series of interrelated implicit or explicit options. In such cases, more sophisticated stochastic modelling is likely to be needed.

Consistency with current market prices

E7 This appendix distinguishes two types of variable:

(a) market variables: variables that can be observed in, or derived directly from, markets (eg prices of publicly traded securities and interest rates)

(b) non-market variables: all other variables (eg the frequency and severity of insurance claims and mortality).

Market variables

E8 Estimates of market variables should be consistent with the observable market prices at the end of the reporting period. An insurer should not substitute its own estimate for the observed market prices, even if other evidence causes the insurer to believe that those prices are unrepresentative of conditions at the end of the period.

E9 Market prices blend a range of views about possible future outcomes and also reflect the risk preferences of market participants. Therefore, they are not a single point forecast of the future outcome. If the actual outcome differs from the previous market price, this does not mean that the market price was 'wrong'.

Non-market variables

E10 Estimates of non-market variables should reflect all available evidence, both external and internal.

E11 Market prices overrule all other forms of evidence. However, non-price external data (eg national mortality statistics) may have more or less weight than internal data (eg internal mortality statistics), depending on the circumstances. For example, a life insurer should not rely solely on national mortality statistics, but should consider all other available internal and external sources of information in developing unbiased estimates of probabilities for mortality scenarios. In developing those probabilities, an insurer should consider all evidence available, giving more weight to evidence that is more persuasive. For instance, internal mortality statistics may be more persuasive than national mortality data if the internal statistics are derived from a large population, the demographic characteristics of the insured population differ significantly from those of the national population and the national statistics are out of date; in that case, an insurer would place more weight on the internal data and less weight on the national statistics. Conversely, if the internal statistics are derived from a small population with characteristics believed to be close to those of the national population, and the national statistics are current, an insurer would place more weight on the national statistics.

E12 Estimated probabilities for non-market variables should not contradict observable market variables. For example, estimated probabilities for future inflation rate scenarios should be consistent with probabilities implied by market interest rates. Paragraphs E13 and E14 discuss this notion further.

E13 In some cases, an insurer concludes that market variables vary independently of non-market variables. If so, the insurer should prepare scenarios that reflect the range of outcomes for the non-market variables and each scenario should use the same observed value of the market variable.

E14 In other cases, market variables and non-market variables may be correlated. For example, there may sometimes be evidence that lapse rates are correlated with interest rates. Similarly, there may be evidence that claim levels for house or car insurance are correlated with economic cycles and hence with interest rates and expense levels. In such cases, an insurer should develop scenarios for each outcome of the variables. The insurer should calibrate the probabilities for the scenarios, and the margins relating to the market variables, so that they are consistent with market prices.

Source of estimates

E15 An insurer estimates the probabilities associated with future payments under existing contracts on the basis of:

(a) information about claims already reported by policyholders.

(b) other information about the known or estimated characteristics of the book of insurance contracts.

(c) historical data about the insurer's own experience, supplemented where necessary by historical data from other sources. Historical data are adjusted if, for example:

(i) the characteristics of the book differ (or will differ, because of adverse selection) from that of the population used as a basis for the historical data.

(ii) there is evidence that historical trends will not continue, that new trends will emerge or that economic, demographic and other changes may affect the cash flows arising from the existing contracts.

(iii) there have been changes in items such as underwriting procedures and claims management procedures that may affect the comparability of historical data.

(d) if available, recent market prices for transfers of books of insurance contracts, adjusted for:

(i) known differences between those books and the book being measured.

(ii) implicit or explicit amounts embedded in those prices that are attributable to future benefits from the relationship with policyholders rather than to the existing contracts.

(e) if available, current reinsurance prices, adjusted for factors that may cause the reinsurance price to differ from the price for a true transfer. Reinsurance prices are not generally true exit prices because reinsurance transactions do not typically extinguish the cedant's obligation to the policyholder. Also, reinsurance often covers only part of the cedant's liability. In addition, the price for reinsurance may be affected by the relationship between the cedant and the reinsurer.

(f) if available, current prices for instruments (if any) covering similar risks such as catastrophe bonds and weather derivatives, adjusted for differences between the risk covered by these instruments and the risk covered by the insurance contracts.

Using current estimates

E16 In estimating the probability of each cash flow scenario relating to non-market variables, an insurer should use all available current information about conditions at the end of the reporting period. An insurer should review its estimates of probabilities at the end of the reporting period and update them if evidence indicates that previous estimates are no longer valid. In doing so, an insurer should consider both:

(a) whether the updated estimates represent faithfully conditions at the reporting date.

(b) whether changes in estimates represent faithfully 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 the estimates to the other end of the range at the end of the period would not faithfully represent what has happened during the period. If an insurer's most recent estimates are, initially, out of line with previous estimates, but conditions have not changed, the insurer should assess carefully whether the probabilities assigned to each scenario have changed since the beginning of the period. In updating its estimates of those probabilities, the insurer should consider both the evidence that supported its previous estimates and all available new evidence, giving more weight to evidence that is more persuasive.

E17 Current estimates of expected cash flows are not necessarily identical to the most recent actual experience. For example, suppose that mortality experience last year was 20 per cent worse than previous experience and

previous expectations. A current estimate of expected death benefits does not typically change immediately by as much as 20 per cent. Several factors could have caused the sudden change in experience, including:

(a) lasting changes in mortality

(b) 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)

(c) flaws in the estimation model, or mis-calibration of parameters used in the model

(d) random fluctuations

(e) identifiable non-recurring causes.

E18 An insurer should investigate the reasons for the change in experience and develop new probability estimates for each possible outcome, in the light of the most recent experience, earlier experience and other information. Typically, the result for this example would be that the expected present value of death benefits increases, but not by as much as 20 per cent. Actuaries have developed various 'credibility' techniques that an insurer could use in assessing how new evidence affects the probability of different outcomes. In this example, if mortality continues to run significantly above previous estimates, the estimated probability assigned to high-mortality scenarios will increase gradually as new evidence becomes available.

Future events

E19 If future events may affect the net cash flows arising from an existing insurance liability, the insurer should develop cash flow scenarios that reflect those future events, as well as unbiased estimates of the probability weightings for each scenario. In contrast, the insurer should not develop cash flow scenarios reflecting future events that create new obligations (or change or discharge existing obligations). For example, an insurer should not develop scenarios reflecting possible new legislation that would create, change or discharge the obligation itself. [This paragraph is consistent with the June 2005 exposure draft proposing amendments to IAS 37, but the wording is modified to focus more on the need to consider all scenarios. The Board plans to update this wording when it completes its redeliberations of that exposure draft.]

E20 Estimates of non-market variables consider not just current information about the current level of insured events, but also information about trends. For example, mortality rates have declined consistently over long periods in many countries. In developing cash flow scenarios, an insurer should assign probabilities to each possible trend scenario in the light of all available evidence.

E21 Similarly, if contractual cash flows are sensitive to inflation, cash flow scenarios should reflect possible future inflation rates. Because inflation rates are likely to be correlated with interest rates, an insurer should calibrate the probabilities for each inflation scenario so that they are consistent with probabilities implied by market interest rates.

E22 Probability weightings should reflect conditions at the end of the reporting period. For example, there may be a 20 per cent probability at the balance sheet date that a major storm will strike during the remaining six months of an insurance contract. Assume that after the balance sheet date and before the financial statements are authorised for issue, a storm actually strikes. The measurement of the liability under that contract does not reflect the storm that, with hindsight, is known to have occurred. Instead, the measurement reflects the 20 per cent probability that was apparent at the balance sheet date (with an appropriate risk margin that reflects conditions at the end of the reporting period, and appropriate disclosure that a non-adjusting event occurred after the end of the reporting period[*]).

E23 The scenarios developed should include unbiased estimates of the probability of catastrophic losses under existing contracts. For example, if there is a 5 per cent probability that an earthquake during the remaining term of an existing contract will cause losses with a present value of CU1,000,000, the expected present value of the cash outflows includes CU50,000 (CU1,000,000 @ 5 per cent) for those catastrophe losses (with an appropriate risk margin for the possibility that existing contracts may generate greater losses). However, the scenarios exclude possible claims under possible future contracts.

[*] See IAS 10 *Events After the Balance Sheet Date*

Which cash flows?

E24 Estimates of cash flows in a scenario should include all cash flows arising in that scenario from the contractual rights and contractual obligations associated with the existing insurance contracts, and no others. The relevant cash flows include:

(a) payments to (or on behalf of) policyholders under existing contracts, including claims that have already been reported but not yet paid (reported claims), claims that have already been incurred but not yet reported (IBNR), and all future claims and other benefits under existing contracts. [The Board expects to add some discussion of constructive obligations when it has completed its redeliberations of the June 2005 exposure draft proposing amendments to IAS 37.]

(b) claim handling expenses (expenses that the insurer will incur in processing and resolving claims under existing contracts, including legal and adjuster's fees and internal costs of processing claim payments).

(c) the direct and indirect costs that market participants would incur in providing contractual benefits that are paid in kind.*

(d) net cash outflows resulting from policyholder behaviour that is unfavourable to the insurer (for example, selective lapses by policyholders who present lower risks).

(e) enforceable cash inflows (eg enforceable premium adjustments and enforceable instalment premiums) from policyholders under existing contracts.

(f) premiums that the policyholder must pay to retain guaranteed insurability, and additional policyholder benefits resulting from those premiums. 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.

(g) cash flows that will result in the scenario from options and guarantees embedded in the contract. When contracts contain embedded options or guarantees, it is particularly important to consider the full range of scenarios.

(h) policy administration and maintenance costs, including all direct and indirect costs that market participants would consider in assessing the acceptability of a price for taking over the contractual rights and contractual obligations.

(i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or can be attributed to them on a reasonable and consistent basis.

(j) potential recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent they do not qualify for recognition as separate assets, potential recoveries on past claims.

(k) payments to policyholders to satisfy existing obligations to pay participating benefits, to the extent that those obligations qualify for recognition as a liability.

(l) interest that the insurer expects to credit to policyholder accounts to satisfy a legal or constructive obligation in a universal life contract.

E25 The following cash flows are not relevant in estimating the current exit value of existing insurance liabilities:

(a) investment returns. The investments are recognised, measured and presented separately. However, the measurement of the insurance liability is:

(i) increased by liability cash flows, if any, that depend on the investment returns.

(ii) decreased by implicit or explicit fees that the insurer will charge under the insurance contract for investment management. Those fees are included to the extent they result from

* If market participants would require a service margin for providing those contractual benefits, the current exit value of the liability includes that margin.

unfavourable policyholder behaviour, are enforceable or will arise from policyholder action needed to retain guaranteed insurability (paragraph E24(d)–(f)).

(iii) increased by the costs that market participants would incur in providing investment management services and the service margin that market participants would require for those services. Chapter 3 discusses service margins. If the contractual investment management fees are in line with what market participants would require, the fees in (ii) equal the costs plus required service margin in (iii).

(b) payments to and from reinsurers. Reinsurance assets are recognised, measured and presented separately.

(c) net cash inflows resulting from policyholder behaviour other than the payment of premiums to retain guaranteed insurability.

(d) cash flows that may arise from future insurance contracts. Nevertheless, estimates of cash flows from existing contracts are not performed on a run-off basis. In other words, those estimates do not incorporate the changes that could occur to cash flows from existing contracts if the insurer stopped issuing new contracts.

(e) income tax payments and receipts (recognised, measured and presented separately under IAS 12 *Income Taxes*).

(f) cash flows between different components of the reporting entity, such as between policyholder funds and shareholder funds. An example of such cash flows is when a policyholder fund owns an office building that is rented to the insurer at an arms' length rent for use in the insurer's own operations.

(g) transaction costs that the insurer would incur in negotiating and implementing a transfer of its contractual rights and obligations to a third party. These costs are not relevant until the insurer is obliged to incur them.

(h) cash flows that would not arise for other market participants if they held the current insurer's rights and obligations under the insurance contract (entity-specific cash flows).

E26 No pricing or measurement model can guarantee to identify in advance all events that might cause insured losses. In determining an acceptable price for taking over insurance liabilities, market participants would consider the possibility of such unidentified events. Because insurance contracts provide asymmetric pay-offs, such unidentified events tend to result in more large losses than large gains. Therefore, they tend to increase the expected present value of future net cash outflows. However, to deal with the possibility of unidentified events insured by existing contracts, it may sometimes be more practical to increase the risk margin, rather than include additional scenarios.

Entity-specific cash flows

E27 The objective is to estimate the current exit value of the rights and obligations associated with the insurance contracts themselves, without considering cash flows attributable to other assets and liabilities or to goodwill. It follows that cash flow scenarios exclude cash flows that other market participants would not generate (or suffer) if they held the contracts. Examples might include:

(a) the presence of superior claims management skills, managerial skills or distribution network, an unusually effective system for detecting fraud, actions that limit lapse rates, a monopolistic market position, special tax circumstances that affect only the insurer and would not affect other market participants, or synergies with the insurer's other assets or liabilities.

(b) an intention to settle insurance liabilities differently from the way that other market participants would settle them. For example, an insurer may decide to use its own garages to service motor claims, whereas other market participants might prefer to pay third parties and so incur the costs incurred by those third parties. However, if the insurance contract requires the insurer to settle the liability in a particular way, the measurement of the liability must reflect that requirement, because the objective is to measure the liability that exists in fact, rather than a hypothetical liability with different terms.

(c) unusually efficient, or unusually inefficient, administration systems. Estimates of servicing costs 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. If other insurers incur higher or lower servicing costs, an insurer would need to assess whether the difference arises from the characteristics of the contracts or from differences in efficiency.

E28 Estimates of non-market variables should reflect the characteristics of the existing insurance contracts, not a hypothetical portfolio of standardised liabilities. For example, unbiased mortality estimates should reflect, as far as possible, the demographics of the portfolio being measured. Although these estimates are portfolio-specific, they are not necessarily entity-specific. In other words, they are not necessarily inconsistent with estimates that other knowledgeable market participants would make about that portfolio. Moreover, there will rarely be persuasive evidence that the insurer's estimates differ from estimates that other market participants would make.

Appendix F
Risk margins

F1 This appendix is a preliminary draft of guidance on estimating risk margins. The guidance applies to all forms of insurance liability (eg life and non-life, direct insurance and reinsurance).

Overall principle

F2 The risk margin should be an explicit and unbiased estimate of the margin that market participants require for bearing risk.

Objective and characteristics of a risk margin

F3 The objective of including a risk margin in the measurement of an insurance liability is to convey useful information to users about the uncertainty associated with the liability. To achieve this objective, an insurer should select an approach for determining risk margins that meets the following criteria:

(a) Because insurance liabilities are measured at current exit value, the risk margin should be consistent with the margin that would be expected if the insurer were to transfer its contractual rights and obligations to another party.

(b) Risk margins should be explicit, not implicit. That is an important change from many existing practices that rely on estimates incorporating an implicit (and often unstated) degree of conservatism or prudence. Separating explicit estimates of future cash flows from explicit risk margins should improve the quality of estimates and enhance transparency.

(c) The risk margin for an insurance liability should reflect all risks associated with the liability.

(d) The risk margin for an insurance liability should not reflect risks that do not arise from the liability, such as investment risk (except when investment risk affects the amount of payouts to policyholders), asset-liability mismatch risk or general operational risk relating to future transactions.

(e) The margin should be as consistent as possible with observable market prices (see paragraphs F5–F8).

(f) The approach should be implementable at a reasonable cost and in a reasonable time, and be auditable.

(g) The approach should not ignore the tail risk in contracts with very skewed pay-offs, such as contracts that contain embedded options (eg the interest guarantees and other financial guarantees embedded in many life insurance products) or that cover low-frequency high-severity risks (such as earthquake), or portfolios that contain significant concentrations of risk. For example, if a large portfolio of insurance contracts is subject to significant earthquake risk but the insurer estimates that the probability of an earthquake is only 1 per cent, the approach should not ignore that risk if market participants could be expected to consider that risk in determining a price that they would regard as acceptable.[*] Option-pricing methods or stochastic modelling may be needed to provide effective estimates of the risk margins associated with these items.

(h) The approach should make it easy to provide concise and informative disclosure, and for users to benchmark the insurer's performance against the performance of other insurers.

(i) If more than one approach is compatible with the above criteria, it is preferable to select an approach that builds on models that insurers use (or are developing) to run their business. For example, an

[*] The tail risk affects both (1) the expected cash flows and (2) the margin that market participants would require to compensate them for possible variations from the expected cash flows. Estimates of expected cash flows need to capture the effect that tail risk has on (1). The risk margin needs to capture the effect of tail risk on (2).

insurer may be able to build on an economic capital model, an embedded value model or a model developed for solvency, if the resulting approach is compatible with the above criteria.

(j) The approach should not overlook model risk (the risk that a model is not a good description of the underlying process) or parameter risk (the risk that a model uses estimates of parameters that differ from the true parameters, or that the parameters may change over time). However, because it may be difficult to quantify these risks and price them, care should be taken in building them into a model.

F4 The characteristics of the risk margin are likely to include the following:

(a) The less that is known about the current estimate and its trend, the higher the risk margin should be.

(b) Risks with low frequency and high severity will have higher risk margins than risks with high frequency and low severity.

(c) For similar risks, long duration contracts will have higher risk margins than those of shorter duration.

(d) Risks with a wide probability distribution will have higher risk margins than those risks with a narrower distribution.

(e) To the extent that emerging experience reduces uncertainty, risk margins will decrease, and vice versa.

Calibration to market prices

F5 In general, insurance liabilities expose insurers to risks associated with both market variables (ie variables, such as interest rates, that can be derived from market prices) and non-market variables (such as the frequency and severity of claims, and mortality). It follows that risk margins for insurance liabilities include components related to market variables and components related to non-market variables. Because the risks may have joint effects, the total risk margin may not equal the sum of the margins that would be appropriate for each risk individually.

F6 Paragraph F3(e) states that margins should be as consistent as possible with observable market prices. Therefore, the component(s) of the risk margin that relate(s) to market variables should be consistent with the observed prices from which those variables are derived. Market variables may also provide some (probably limited) indications of how market participants might price the risks associated with non-market variables, particularly for risks that have profiles similar to those of market variables.

F7 Explicit risk margins should not be included for market variables derived from market prices that already include implicit risk margins. For example, if the discount rate is derived from the price of a traded debt security, that discount rate incorporates the margin required by market participants for bearing the risk of changes in interest rates. Including an explicit margin for that risk would be double-counting.

F8 In some cases, a replicating asset exists for some or all of the contractual cash flows arising from an insurance contract. A replicating asset is one whose cash flows exactly match those contractual cash flows in amount, timing and uncertainty. The current exit value of those contractual cash flows equals the fair value of the replicating asset. Thus, if the fair value of the replicating asset is observable or determinable, the insurer can estimate the current exit value of those contractual cash flows without estimating their expected present value and without determining an explicit risk margin.

Approaches to determining risk margins

F9 Listed below are various approaches that might be used in estimating risk margins. In the Board's preliminary view, none is demonstrably better than all others in all circumstances, or demonstrably worse than all others in all circumstances. This list is not intended to be exhaustive. It may be possible to combine some elements from more than one of these techniques if the resulting combination satisfies the criteria identified above.

(a) Confidence levels:

(i) explicit confidence levels (eg 75 per cent probability of sufficiency).

(ii) explicit minimum confidence level, but insurers may use a higher confidence level. [An approach of this type is in use in Australia.]

(b) Conditional tail expectation (CTE), sometimes known as tail value at risk (Tail VaR). CTE is the expected value of the tail of a probability distribution. For example, CTE 90 is the expected value of all outcomes beyond the 90th percentile.

(c) An explicit margin within a specified range. Accounting or actuarial guidance specifies the ends of the range (perhaps, as a percentage of the central estimate) and indicates criteria for deciding whether the margin should be set nearer one end of the range. [An approach of this type is in use in Canada.]

(d) Cost of capital. The estimated 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, if any. [The CRO Forum* suggests that an approach of this type might be suitable for both general purpose financial reporting and for reporting to supervisors. The suggested approach uses a 'replicating portfolio' of traded financial instruments to price the expected cash flows (and thereby also the risk margins associated with market variables), and a cost of capital approach to determine the risk margin associated with non-market variables.]

(e) Methods based on the capital asset pricing model or related asset pricing models.

(f) Adjustments to cash flows to place more weight on cash flows in some outcomes (eg 'deflator', 'no arbitrage' and 'market consistent' approaches) or to place more weight on larger cash outflows or smaller cash inflows (eg 'transformation' or 'distortion' approaches).

(g) Multiples of one or more specified parameters of the estimated probability distribution (eg multiples of the standard deviation, variance, semi-variance, or higher 'moments' of the distribution).

(h) A risk-adjusted discount rate. This approach is relatively simple and may be easy to benchmark against what other entities are doing. It may provide a reasonable indication of the pattern of release from risk if risk is directly proportional to the amount of the liability and the remaining time to maturity. However, insurance liabilities do not always have these characteristics. For example, 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.

F10 The following approaches do not meet the criteria proposed above.

(a) Implicit (and unspecified) confidence level.

(b) Implicit (but unspecified) risk margin through use of conservative assumptions that aim to give reasonable assurance at an implicit confidence level that ultimate cash payments will not exceed the recognised liability. Terms sometimes used in this context are 'sufficiency' (eg a high probability that amounts paid will not exceed the reported liability), 'provision for risk of adverse deviation' and prudence.

* The CRO Forum is a forum for the chief risk officers of major European insurers.

Appendix G Examples

Example 1 – Compensation for bearing risk or shock absorber?

Background information

On 1 January 20X1, insurer A issues several identical insurance contracts to various policyholders. The contracts cover insured events occurring between 1 January 20X1 and 31 December 20X1. At inception, the expected value of the cash outflows from the contracts is CU* 200, spread evenly through the year. For simplicity, this example ignores the time value of money, and investment income. Insurer A expects to pay all valid claims immediately.

Insurer A determines that it requires an additional payment of CU40 to compensate it for bearing the risk associated with the contracts. Insurer A charges a premium of CU240 and collects the entire premium at inception.† Insurer A estimates that other insurers would not require a significantly different return.‡

At 30 June 20X1, insurer A pays claims totalling CU118. Insurer A estimates that no other insured events had occurred up to that date. Therefore, insurer A recognises revenue (earned premium) of CU120 and claims expense of CU118. At that date, insurer A estimates that claims for the six months to 31 December 20X1 will have an expected value of CU118. Insurer A also estimates that it (and other insurers) would require CU25 to compensate it for bearing the risk that the claims for those six months might exceed CU118 (but cannot charge that additional amount because the pricing was set at inception).

At 31 December 20X1, insurer A pays claims of CU118 (ie the same amount as the expected value determined at 30 June 20X1).

View A (shock absorber)

If risk margins are viewed as a shock absorber, at 30 June 20X1 insurer A recognises a liability of CU120 (6/12 of the original premium). That measurement could also be analysed as the (revised) expected value of CU118 plus an implicit risk margin of CU2.

In the six months to 31 December 20X1, insurer A recognises revenue (earned premium) of CU120 and claims expense of CU118. The net profit of CU2 for those six months corresponds to the release of the implicit risk margin that was included in the liability at 30 June 20X1.

View B (compensation for bearing risk)

If risk margins are viewed as a measure of the compensation for bearing risk, at 30 June 20X1, insurer A recognises a liability of CU143 (118 + 25) and an expense of CU23 (143 – 120) because of the shortfall (premium deficiency). During the six months to 31 December 20X1, insurer A reverses that shortfall, recognising income of CU23. Insurer A also recognises revenue (earned premium) of CU120 and claims expense of CU118. Thus, insurer A's profit for the six months to 31 December 20X1 is CU25.

Comments

Example 1 illustrates several points:

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* CU = currency units

† It is beyond the scope of this example to consider what would happen if the premium is higher or lower than the sum of the expected value of the cash flows (CU200) plus the required compensation for bearing risk (CU40).

‡ It is beyond the scope of this example to consider what would happen if other insurers require a higher or lower return.

- If view A is adopted, insurer A's balance sheet reports the liability as if it were almost free from risk (ie with an implicit risk margin of only CU2).

- Under view A, if insurer A's pricing reacts promptly to changes in estimate, its balance sheet may measure identical liabilities at different amounts. For example, if insurer A issues new six-month contracts on 1 July with exposures identical to the remaining exposures and for a premium of CU143, it will measure the new liabilities at CU143 and the old exposures at CU120, although the exposures are identical.

- If view A is adopted, insurer A's income statement for the first six months will not give a timely reflection of the deterioration in expected outcomes for the second six months.

- If view B is adopted, insurer A recognises an expense of CU23 in the first six months and income of CU23 in the following six months. That income does not reflect cash received by insurer A. It reflects the additional cash that market participants would have required to take over the liability at 30 June 20X1.

Example 2 Calibrating a risk margin to the premium

Background

Insurer B issues an insurance contract on 1 January for a premium of CU1,000, incurring acquisition costs of CU100. Insurer B estimates on 1 January that the cash flows have an expected present value of CU750 and a standard deviation of CU50. Insurer B determines that, for this particular type of insurance contract, market participants would use the estimated standard deviation of the cash flows as the unit of risk. In other words, they would quantify the required compensation for bearing risk as a multiple of the standard deviation.[*] Insurer B estimates that market participants would not require a service margin. On 30 June, insurer B estimates that the remaining cash flows have an expected present value of CU400 and a standard deviation of CU30.

Insurer B estimates that market participants would require a margin of CU2.8 per standard deviation at 1 January and CU2.9 at 30 June.

Chapter 3 describes two implementations of current exit value. This example compares their effects.

Implementation A

On 1 January (inception), insurer B:

- measures the insurance liability at CU900 (premium received: CU1,000 less acquisition costs: CU100). That measurement equals the expected present value of future cash flows (CU750) plus an implicit risk margin of CU150. Therefore, the implicit price per standard deviation is CU3 (total margin of CU150 divided by standard deviation of CU50).
- carries out a liability adequacy test. Market participants would require CU890 to take over the liability (expected cash flows of CU750, plus margin of CU140 = CU50 @ 2.8). That amount is less than the initial measurement of the liability (CU900). Therefore, the liability adequacy test does not result in the recognition of an additional liability.
- recognises the acquisition costs (CU100) as an expense, balanced out by income of CU100.

On 30 June, insurer B:

- measures the liability at CU490 (expected cash flows: 400 plus margin of CU90). The margin is CU90 (standard deviation of CU30 multiplied by the original price per standard deviation [CU3]).
- reports the reduction of CU60 in the margin as income (reduction of CU20 in the standard deviation, priced at CU3 per standard deviation).

Implementation B

At 1 January, insurer B measures the liability at CU890 (expected cash flows of CU750, plus margin of CU140 = CU50 @ 2.8). Therefore, at inception on 1 January, insurer B recognises income of CU110 (premium of CU1,000 less initial liability measurement of CU890) and profit of CU10 (income of CU110 less acquisition costs of CU100).

At 30 June, insurer B:

- measures the liability at CU487 (expected cash flows of CU400, plus margin of CU87 = CU30 @ 2.9).
- recognises income of CU53 relating to the release from risk. That income is made up of:
    - a reduction of CU20 in the standard deviation, priced at CU2.8 per standard deviation (subtotal = CU56), less
    - the increase in the estimated price required by market participants (CU3 = CU0.1 per standard deviation, multiplied by the remaining standard deviation of CU30).

[*] In using this example, the Board does not wish to imply that standard deviation is necessarily an appropriate measure of the quantity of risk. Standard deviation is used here to provide a simple example.

Example 3 Fee for assembling a portfolio

Insurer C issues an insurance contract on 1 January for a premium of CU1,000, incurring acquisition costs of CU100. Insurer C estimates on 1 January that the cash flows have an expected present value of CU750 and that market participants would require a margin of CU140. Thus, the premium covers the following elements:

	CU
Expected present value of cash flows (before margin)	750
Margin associated with cash flows	140
	890
Acquisition costs	100
Fee for portfolio assembly	10
Total premium	1,000

The price for a hypothetical transfer to another party is likely to be about CU890. The initial measurement of the liability is CU900 in implementation A of current exit value (see chapter 3) and CU890 in implementation B.

Assume now the following change in the fact pattern. Insurer C provides separable services at inception and estimates that the fee attributable to them is CU4. Therefore, the implicit fee for assembling the portfolio is CU6. The initial measurement would be CU896 in implementation A and CU890 in implementation B.

Example 4 Service margin

Background

Investment manager D enters into a non-cancellable contract to manage a unitised pool of investments from 1 January 20X1 to 31 December 20X1 on the following terms:

- Investment manager D expects to collect a fee of CU15 on 31 December 20X1 and incur costs of CU5 at that date.
- Investment manager D estimates that other investment managers would require the same fee of CU15 and incur the same costs of CU5.
- Investment managers would typically expect to incur costs of CU2 to originate a similar contract.
- For simplicity, the example ignores the time value of money, risk margins and lapse.

How would market participants value the contractual rights and obligations?

In this example, market participants require an expected investment fee of CU15. Of this, CU5 is needed to pay the expected running costs and CU2 is needed to pay the acquisition costs. Therefore, market participants require an expected net return of CU8 for providing investment management services. After the acquisition costs are paid, the expected future cash flows from the contract are CU10.[*] Therefore, market participants could be expected to value those cash flows at CU2.[†]

Put differently, if an investment manager charges the same fee as other investment managers and incurs the same costs, the value of the contract at inception equals the acquisition costs that market participants would typically incur in originating similar contracts. Furthermore, the value of the contract at inception equals the investment manager's own acquisition costs, unless they are out of line with the acquisition costs that other investment managers would incur.

Contractual fees that exceed market requirements

Extending the example, suppose the contract entitles investment manager D to charge CU16 per contract each year, but other investment managers still only require CU15 (and all other facts remain unchanged). After the acquisition costs are paid, the expected future net cash flows are CU11, but market participants still require only CU8. Therefore, the contract value is approximately CU3.

Contractual fees that do not meet market requirements

Conversely, suppose the contract entitles investment manager D to charge CU12 per contract, but other investment managers still require CU15 (and all other facts remain unchanged). After the acquisition costs are paid, the expected future net cash flows are CU7, but market participants still require net cash flows of CU8. Therefore, the contract value is now a negative amount (a liability) of CU1.

[*] CU15 – CU5

[†] CU10 – CU8

Example 5 Estimating the service margin for investment management contracts

It is often possible to observe how much market participants charge for investment management contracts with relatively standard terms, but it may not be possible to determine how much of the fee is for investment management services and how much is compensation for the origination activity. It may be possible to infer this by looking at the origination costs that typical investment managers incur (not the origination costs that the entity in fact incurred). In doing so, it is important to compare like with like. For example, the fee for a passive manager tracking an index is not an appropriate comparison for an active manager.

It may sometimes be possible to infer how much compensation investment managers require for investment services alone by looking at differences between fees for retail investors and fees for wholesale investors. For example, suppose that market participants generally charge a fee of 1 per cent for retail investors and 0.6 per cent for wholesale investors, and the estimated additional ongoing cost of maintaining a large number of retail investment accounts is 0.25 per cent. If the cost of originating a small number of wholesale contracts is assumed to be negligible, the entire fee of 0.6 per cent required by market participants for wholesale contracts relates to investment management services, rather than origination. This implies that market participants would require a fee of 0.85 per cent (0.6% plus 0.25%) to manage an assembled portfolio of retail contracts. The remaining fee of 0.15 per cent (1.0% – 0.25% – 0.6%) relates to the additional cost and effort involved in originating a large number of retail contracts.

Example 6 Embedded value

Background

An insurer issues insurance contracts on 1 January for a total premium of CU1,000. Expected (probability-weighted) benefit payments are CU950 on 31 December. The expected investment return is 11 per cent. The insurer estimates a risk discount rate of 12 per cent. The insurer is subject to local regulatory requirements. These require the insurer to measure the liability at CU1,040 in its regulatory returns and to hold additional capital of CU60. Thus, on 1 January, investments of CU1,100 (CU1,060 plus CU40) are allocated to these contracts. The insurer determines that it does not need to hold more capital than the regulator requires. The insurer has no other assets and liabilities.

Determining embedded value

At 1 January, the insurer expects the following cash flows from these contracts:

	Expected cash flow 31/12	*Present value 1/1 at 12%*
Premium received (not yet available to shareholders)	1,000	
Investment return on premium	110	
Policyholder benefits	(950)	
Net shareholder cash flow	160	143
Capital injected 1 January	100	
Investment return on capital	11	
Capital released on 31 December (if experience permits)	111	99
Total embedded value		242

The capital injected on 1 January is CU100, but the present value of the capital release on 31 December is only CU99. Therefore, the cost of holding the required capital is CU1.

Assume the insurer uses the regulatory basis to measure its insurance liability for general purpose financial reporting. If the insurer's financial statements include embedded value, they appear as follows:

Balance sheet	*1 January*	*31 December*
Investments	1,100	271
Embedded value asset (note 1)	182	–
Insurance liability	(1,040)	–
Equity (= embedded value, in this example)	242	271

Income statement	*At 1 January*	*2 January to 31 December*
Gain on new business (note 1)	142	
Interest on embedded value (unwind of discount)		29
Embedded value profit	142	29

Changes in equity	*1 January*	*2 January to 31 December*
Start of year	100	242
Embedded value profit	142	29
End of year	242	271

Note 1 Embedded value asset at inception	*1 January*
Present value at inception of future net shareholder cash flow (CU160 / 1.12)	143
Cost of holding required capital (see above)	(1)
Gain on new business	142
Conservative regulatory measurement of liability (CU1,040 – CU1,000)	40
Embedded value asset	182

Three final points are worth noting:

- If the insurer changes its asset mix, the embedded value is likely to change. For example, suppose the insurer invests in riskier assets with an expected return of 15 per cent. The embedded value will rise, unless a corresponding adjustment is made to the discount rate.

- In this example, the embedded value asset reported depends on the measurement of the liability. Here, a conservative regulatory valuation of CU1,040 increases the embedded value asset reported, though there is no overall effect on reported equity or profit. In other words, hidden margins of CU40 in the liability cause an increase of CU40 in the embedded value asset.

- Embedded value could be used directly to measure the liability, without recognising a separate asset. The embedded value measurement of the liability would be CU858 (CU1,040 – CU182).

Example 7 Beneficial policyholder behaviour

This example provides more detail to support the example in chapter 4. An insurer issues 10,000 two-year term life insurance contracts on 1 January X1 as follows:

(a) Annual premium of CU575.80 payable on 1 January. This pricing produces a break-even result at the end of X2 if actual experience is in line with the estimates.

(b) Death benefit of CU10,000 for deaths between 1 January X1 and 31 December X2, paid on 31 December of the year of death. No benefit is paid to survivors.

(c) If the policyholder does not pay the premium due on 1 January X2, the policy lapses at that date: no surrender value is paid and no death benefit is paid for deaths in X2.

(d) On 1 January X1, all policyholders are healthy. The insurer estimates that 10 per cent of policyholders will become unhealthy 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.

(e) Estimated annual mortality rates are 5 per cent for healthy policyholders and 20 per cent for unhealthy policyholders.

(f) Estimated lapse rates at the end of X1 are 10 per cent for healthy policyholders and 1 per cent for unhealthy policyholders.

(g) 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 in chapter 4.

The following table shows the number of policyholders if actual experience is in line with estimates.

Number of policyholders	*healthy*	*unhealthy*	*total*
At 1 January	10,000		10,000
Deaths X1	(500)		(500)
Transfer to unhealthy	(950)	950	0
End of X1 (before lapses)	8,550	950	9,500
Lapses end of X1	(855)	(10)	(865)
End of X1 (after lapses)	7,695	940	8,635
Deaths X2	(385)	(188)	(573)
End of X2	7,310	752	8,062

The following table shows the cash flows if actual experience is in line with estimates.

Cash flows	*CU000 healthy*	*CU000 unhealthy*	*CU000 total*
Premiums 1/1/X1	5,758		5,758
Death benefits 31/12/X1	(5,000)		(5,000)
Cash 31/12/X1	758	0	758
Premiums 1/1/X2	4,431	541	4,972
Death benefits 31/12/X2	(3,850)	(1,880)	(5,730)
Cash end of X2	1,339	(1,339)	0

Possible accounting treatments

The following table shows how the insurer's balance sheet might look under each of four approaches to future premiums and policyholder benefits. 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.

Balance sheet end of X1	A exclude all future premiums	B unhealthy only (with lapse of unhealthy)	C unhealthy only (no lapse of unhealthy)	D healthy and unhealthy
	CU000	*CU000*	*CU000*	*CU000*
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	758	(581)	(595)	0

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.

- 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, recognising 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 breakeven pricing for zero gain and zero loss. As noted above, this example excludes the time value of money and risk margins.

Example 8 Acquisition costs: single premium contract

On 1 January 20X1 an insurer issues a large number of life insurance contracts with the following features:

(a) Policyholders pay premiums totalling CU12,000 on 1 January.

(b) The contracts are in force until 31 December 20Y0. Over the ten-year life of the contracts, the expected death benefits are CU8,400. Most deaths are expected to occur in the later part of the contract term. In particular, no deaths are expected in January 20X1.

(c) For simplicity, the time value of money is ignored.

(d) The insurer incurs acquisition costs of CU1,200 on 1 January 20X1. There are no other expenses.

(e) The contracts have no surrender value (ie the surrender value is zero).

(f) The contract provides an implicit margin (for bearing risk and providing other services) of CU2,400 (premiums of CU12,000 less death benefits of CU8,400 less acquisition costs of CU1,200). Assume that other market participants would require a similar margin for identical contracts.

(g) The release from risk is assumed to be constant over the life of the contract (CU20 per month).

(h) There are no changes in estimates during the period covered by the example (1–31 January 20X1).

As chapter 4 notes, some argue that an insurer should recognise an intangible asset to reflect the initial investment made to acquire the customer relationship. They would measure that asset initially at the amount of acquisition costs incurred. They would amortise that asset as the insurer recovers the acquisition costs. The following table applies that approach to example 8. It shows the insurer's balance sheet at 1 January 20X1 (after the acquisition costs and before the first premium) and 31 January 20X1 (just before the second premium), and its income statement at inception and for the next month (next month excludes inception).

Balance sheet	*Note*	*1/1/X1*	*31/1/X1*
Cash		10,800	10,800
Customer relationship	1	1,200	1,190
Insurance liability	2, 3	(12,000)	(11,970)
Equity		()	20

Income statement	*Note*	*1/1/X1 inception*	*31/1/X1 1 month*
Premiums received		12,000	–
Change in insurance liability	3	(12,000)	30
Amortisation of customer relationship	1	–	(10)
Profit		–	20

Note 1 Customer relationship	*1/1/X1*	*31/1/X1*
Opening carrying amount	()	1,200
Acquisition costs incurred	1,200	()
Amortisation	()	(10)
Closing carrying amount	1,200	1,190

Assumes a constant amount (CU10) of each monthly premium is regarded as a recovery of the customer relationship.

Note 2 Insurance liability	*1/1/X1*	*31/1/X1*
Present value of future death benefits	8,400	8,400
Margin	2,400	2,380
Sub-total	10,800	10,780
Allocation of premiums to recover customer relationship	1,200	1,190
Carrying amount	12,000	11,970

Note 3 Insurance liability: changes	*1/1/X1*	*31/1/X1*
Premium received	12,000	–
Allocation of premium to recover customer relationship	–	(10)
Release from risk	()	(20)
Net change	12,000	(30)
Opening carrying amount	–	12,000
Closing carrying amount	12,000	11,970

The following balance sheet and income statement show how the Board's preliminary views would apply to this example.

Balance sheet	*Note*	*1/1/X1*	*31/1/X1*
Cash		10,800	10,800
Insurance liability	4, 5	(10,800)	(10,780)
Equity		–	20

Income statement	*Note*	*1/1/X1 inception*	*31/1/X1 1 month*
Profit at inception before acquisition costs		1,200	–
Acquisition costs		(1,200)	–
Net profit at inception		–	–
Premiums received		12,000	–
Change in insurance liability	5	(12,000)	20
Profit		–	20

Chapter 7 discusses a margin presentation that differs from the above presentation. A margin presentation would:

(a) show premiums as deposit receipts (rather than revenue) and change in insurance liability as deposit repayments (rather than income or expense).

(b) label the income of CU20 for the period from 2 January to 31 January X1 as 'release from risk', rather than 'change in liabilities'.

Note 4 Insurance liability	*1/1/X1*	*31/1/X1*
Present value of future death benefits	8,400	8,400
Margin	2,400	2,380
Carrying amount	10,800	10,780

Note 5 Insurance liability: changes	*1/1/X1*	*31/1/X1*
Gain at inception before acquisition costs	(1,200)	–
Premiums received	12,000	()
Release from risk	–	(20)
Opening carrying amount	–	(10,800)
Closing carrying amount	(10,800)	(10,780)

Comments on example 8

Example 8 illustrates the following points:

(a) If the pricing is in line with what market participants require, the two approaches lead to a similar net result at inception, but they split out different assets and liabilities.

(b) In this example, policyholders pay CU8,400 for expected benefits plus margin of CU2,400 (total CU10,800), as well as CU1,200 for acquisition costs. The approach that presents a separate intangible, equal to the acquisition costs, has the following effects:

  (i) It reports a liability of CU12,000, even though the obligation is only CU10,800 (expected cash flows of CU8,400 plus margin of CU2,400). Put differently, if the insurer could issue the same contracts incurring negligible acquisition costs, it would be willing to charge CU10,800 for an identical liability. Similarly, a transferee incurring negligible acquisition costs would accept the liability for CU10,800.

  (ii) It reports a customer relationship 'asset' of CU1,200, even though the related cash flows have already been received.

  (iii) It must subsequently amortise the customer relationship 'asset' on an arbitrary basis that depends entirely on the measurement of the related liability and would not provide useful information. This demonstrates that the customer relationship 'asset' has no independent economic meaning and is simply a by-product of an over-measurement of the liability.

If the contract had a surrender value at inception equal to the premium paid (CU12,000), there might be some rationale in measuring the liability at the surrender value of CU12,000 and recognising a separate customer intangible of CU1,200 (in which case, the measurement of that asset would equal the acquisition costs incurred). However, that rationale would not apply if the surrender value were any other amount, and would be difficult to apply convincingly in subsequent measurement.

Example 9 Acquisition costs: regular premium contract

The fact pattern is the same as in example 8, with the following differences:

(a) The premiums are CU100 per month (CU12,000 over the life of the contracts). To permit a clearer comparison with example 8, example 9 keeps the same total premiums and the same pattern of premiums. In a more comprehensive example, total monthly premiums would decline over the life of the contract because of death and lapses.

(b) The insurer expects that lapses will be negligible. Also, the additional risk margin for the risk of lapses is assumed to be negligible.

The following table applies the Board's preliminary views to example 9 at 1 January 20X1 and 31 January 20X1.

Balance sheet	*Note*	*1/1/X1*	*31/1/X1*
Customer relationship	6, 7	1,100	1,120
Cash (overdraft)		(1,100)	(1,100)
Equity		–	20

Income statement	*Note*	*1/1/X1 inception*	*31/1/X1 1 month*
Initial recognition of customer relationship		1,200	–
Acquisition costs		(1,200)	–
Net gain at inception		()	–
Premiums received		100	–
Change in customer relationship	7	(100)	–
Release from risk on customer relationship		–	20
Profit		–	20

A margin presentation (as in example 15) would not show the lines labelled 'premiums received' and 'change in customer relationship'.

Note 6 Customer relationship	1/1/X1	31/1/X1
Present value of future premiums	11,900	11,900
Present value of future death benefits	(8,400)	(8,400)
Sub-total	3,500	3,500
Margin	(2,400)	(2,380)
Carrying amount	1,100	1,120

Note 7 Customer relationship: changes	1/1/X1	31/1/X1
Initial recognition of customer relationship	1,200	–
Premium received	(100)	–
Release from risk	–	20
Opening carrying amount	–	1,120
Closing carrying amount	1,100	1,120

Initial comments on example 9

The example shows the net cash flows the insurer expects from the contract. In the early years of the contract, the future cash flows are net inflows and so an asset is recognised. In later years, there is a net cash outflow, so a liability will be recognised. In this example, that switch from an asset to a liability occurs when cumulative net cash inflows (premiums less death benefits) exceed CU1,200.

Because this example includes only contracts issued simultaneously, the overall result of the measurement is an asset, described above as a customer relationship. In a more realistic example, those contracts would be included in a larger portfolio, typically measured as a net liability.

The asset recognised incorporates expected (ie probability-weighted) lapses (assumed zero in this example), the time value of money and a risk margin for all risks, including lapse risk. Because of the simplified fact pattern, this example does not illustrate these factors.

Because no profit or loss was recognised at inception, the initial measurement of the asset (before the first premium) equals the acquisition costs.

Separating the liability from the customer relationship?

How would example 9 look if the customer relationship were presented separately from the insurance liability? The initial measurement of CU1,100 could be viewed as having three components:

(a) The obligation to pay benefits if the policyholder pays no further benefits. This is made up of the surrender value (zero in this case) plus the stand-ready obligation to pay death benefits in January (nil at 31 January X1 if all deaths are reported immediately and assumed to be, say, CU3 at 1 January X1, made up of expected cash flows of approximately zero and a risk margin of CU3).

(b) The stand-ready obligation to accept further premiums during the rest of the contract term from those policyholders for whom the present value of the resulting additional benefits exceeds the present value of those further premiums. For illustration, the example assumes this is CU35 at both 1 January X1 and 31 December X1 (made up of expected cash flows of CU20 and risk margin of CU15).

(c) The customer relationship (the difference between the measurement of the whole portfolio and the two components identified in (a) and (b)).

With these assumptions, the balance sheet would appear as follows.

Balance sheet	*Note*	*1/1/X1*	*31/1/X1*
Customer relationship	8, 9	1,138	1,155
Insurance liability		(38)	(35)
Customer relationship less insurance liability		1,100	1,120
Cash (overdraft)		(1,100)	(1,100)
Equity		–	20

This presentation leaves the overall measurement unchanged, but splits it into two separate components (the customer relationship and the insurance liability).

Income statement	*Note*	*1/1/X1 inception*	*31/1/X1 1 month*
Initial recognition of:			
customer relationship		1,238	–
insurance liability		38	–
Acquisition costs	–	1,200	–
Profit at inception		–	–
Premiums received		100	–
Change in customer relationship		(100)	–
Release from risk on customer relationship	9	–	17
Release from risk on insurance liability	8	–	3
Profit		–	20

A fee presentation (as in example 14) and a margin presentation (as in example 15) would not show the lines labelled ‘premiums received’ and ‘change in customer relationship’.

Note 8 Customer relationship	*1/1/X1*	*31/1/X1*
Present value of future death benefits	11,900	11,900
Present value of future death benefits	(8,400)	(8,400)
Sub-total	3,500	3,500
Plus net cash outflows in insurance liability	20	20
Margin	(2,400)	(2,380)
Add back margin in insurance liability	18	15
Carrying amount	1,138	1,155

Note 9 Customer relationship: changes	*1/1/X1*	*31/1/X1*
Initial recognition (before first premium)	1,238	–
Premium received	(100)	–
Release from risk	–	17
Opening carrying amount	–	1,138
Closing carrying amount	1,138	1,155

Example 10 Non-life insurance, traditional presentation

Paragraphs 301–308 discuss six presentations. Examples 10–15 illustrate them. To focus on the style of presentation rather than recognition and measurement, the examples are simple and all use the same fact pattern, as follows:

- Premium CU1,000, covering insured events between 1 January and 31 December.
- Expected claims (including claims handling costs) CU700. CU350 is paid on 30 June and CU350 on 31 December.
- Acquisition costs CU100, incurred on 1 January.
- Other expenses associated with the administration of the contracts CU80, incurred evenly through the period.
- Expected investment return 8 per cent and risk-free rate used to discount the liability cash flows 5 per cent.
- The insurer estimates that there is no material profit or loss at inception (1 January). On 30 June, the insurer estimates that the appropriate margin is CU69, which results in a liability measurement of CU450 (coincidentally equal to a conventional unearned premium of CU500 less conventional deferred acquisition costs of CU50).
- No differences between actual outcomes and previous estimates.
- This illustration focuses on presenting premiums for a contract that does not include an explicit deposit component.

Example 10 illustrates a traditional presentation for non-life insurance.

Income statement	*Inception 1 Jan*	*2 Jan to 30 Jun*	*1 July to 31 Dec*
Premiums written	1,000		
Change in unearned premium	(1,000)	500	500
Premiums earned	0	500	500
Investment income	0	36	22
Policyholder benefits (claims)		350	350
Expenses		40	40
Amortisation of deferred acquisition costs		50	50
Total expenses	0	440	440
Profit	0	96	82

Balance sheet	*1 Jan*	*30 Jun*	*31 Dec*

Cash	900	546	178
Deferred acquisition costs	100	50	–
Insurance liabilities	(1,000)	(500)	–
Equity	0	96	178
Claims ratio	n/a	70%	70%
Expense ratio (without acquisition costs)	n/a	8%	8%
Combined ratio (without acquisition costs)	n/a	78%	78%
Expense ratio (with acquisition costs)	n/a	18%	18%
Combined ratio (with acquisition costs)	n/a	88%	88%

Example 11 Traditional life insurance presentation

Example 11 uses the same fact pattern as example 10.

	Inception 1 Jan	*2 Jan to 30 Jun*	*1 July to 31 Dec*
Premium revenue	1,000		
Investment income		36	22
Total income	1,000	36	22
Policyholder benefits		350	350
Change in insurance liability	1,000	(500)	(500)
Expenses		40	40
Amortisation of deferred acquisition costs		50	50
Total expenses	1,000	(60)	(60)
Profit	0	96	82

Balance sheet	*1 Jan*	*30 Jun*	*31 Dec*
Cash	900	546	178
Deferred acquisition costs	100	50	
Insurance liabilities	(1,000)	(500)	
Equity	0	96	178

Comments:

1. The line 'change in insurance liability' shows the result of a computation, not the effect of a real economic event.

2. This presentation does not require the insurer to analyse the reasons for changes in the liability. Such analysis may be complex for traditional products that bundle together many elements.

Example 12 Non-life insurance, modified presentation

Example 12 uses the same fact pattern as example 10. The presentation is changed to recognise acquisition costs as an expense when incurred. In addition, the measurement of the insurance liability does not include the part of the premium that recovers the acquisition costs.

Income statement	*Inception 1 Jan*	*2 Jan to 30 Jun*	*1 July to 31 Dec*
Premiums written	1,000		
Change in unearned premium	(900)	450	450
Premiums earned	100	450	450
Investment income	0	36	22
Claims		350	350
Expenses		40	40
Acquisition costs	100	–	–
Total expenses	0	390	390
Profit	0	96	82

Balance sheet	*1 Jan*	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	–
Equity	0	96	178
Claims ratio	0%	78%	78%
Expense ratio (without acquisition costs)	0%	9%	9%
Combined ratio (without acquisition costs)	0%	87%	87%
Expense ratio (with acquisition costs)	100%	9%	9%
Combined ratio (with acquisition costs)	100%	87%	87%

Comment:

1. The ratios differ from those in example 10 because premium of CU100 is recognised as revenue on 1 January (inception), rather than over the life of the contract.

Example 13 Life insurance presentation, modified

Example 13 uses the same fact pattern as example 10. The presentation is changed to recognise acquisition costs as an expense when incurred. In addition, the measurement of the insurance liability does not include the part of the premium received that recovers the acquisition costs.

Income statement	*Inception 1 Jan*	*2 Jan to 30 Jun*	*1 July to 31 Dec*
Premium revenue	1,000		
Investment income		36	22
Total income	1,000	36	22
Claims		350	350
Change in insurance liability	900	(450)	(450)
Expenses		40	40
Acquisition costs	100		
Total expenses	1,000	60	60
Profit	0	96	82

Balance sheet	*1 Jan*	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	
Equity	0	96	178

Example 14 Fee presentation

Example 14 uses the same fact pattern as example 10.

Income statement	*Inception 1 Jan*	*2 Jan to 30 Jun*	*1 July to 31 Dec*
Charges to policyholder account	–	473	461
Policyholder benefits	–	(350)	(350)
Expenses	–	(40)	(40)
Insurance margin	–	83	71
Gross gain at inception	100		
Acquisition costs	(100)		
Net gain at inception	0	0	0
Investment income		36	22
Interest on insurance liability		(23)	(11)
Net interest and investment income	0	13	11
Profit	0	96	178

Balance sheet	*1 Jan*	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	()
Equity	0	96	178

Comments:

1. This format presents all premiums as deposits (except the part needed to pay for acquisition costs), and presents as revenue the explicit or implicit charges made to policyholder accounts.

2. In US GAAP, a somewhat similar presentation is used for universal life contracts. This format is possible for these contracts because the design of the contract unbundles the different contract elements. This approach may be more challenging if charges to policyholders are implicitly bundled into a premium, rather than identified explicitly.

3. In this illustration, there is no explicit policyholder account and, hence, no explicit charge. The amounts shown as policyholder charges are implicit and are computed as the expected value of policyholder benefits and expenses, plus the risk margin (and, if applicable, service margin) released in the period. (The margin presentation in example 15 shows as revenue only the release of those margins.)

Example 15 Margin presentation

Example 15 uses the same fact pattern as example 10.

	Inception 1 Jan	*2 Jan to 30 Jun*	*1 July to 31 Dec*
Insurance margin		83	71
Gross gain at inception	100		
Acquisition costs	(100)		
Net gain at inception	0	0	0
Investment income		36	22
Interest on insurance liability		(23)	(11)
Net interest and investment income	0	14	11
Profit	0	96	82

Balance sheet	*1 Jan*	*30 Jun*	*31 Dec*
Cash	900	546	178
Insurance liabilities	(900)	(450)	–
Equity	0	96	178

Comments:

1. This format is similar to the analysis of changes in embedded value provided by many larger life insurers in the UK, Continental Europe, Australia, New Zealand, Canada and South Africa, and to the 'sources of earnings analysis' provided by some Canadian life insurers.

2. This format treats all premiums as deposits, and all claims expense, claims handling expense and other contract-related expense as repayments of deposits.

3. 'Release of margins' refers to the difference between the margin at the start of the period and the margin at the end of the period. It reports the estimated margin that market participants would have required at the start of the period for bearing risk during the period.

Appendix H
Credit characteristics of insurance liabilities

Introduction

H1 Chapter 5 discusses whether the carrying amount of insurance liabilities should reflect their credit characteristics. This appendix provides a more detailed discussion of this topic.

H2 Although this topic is often described as relating to the entity's credit standing, in fact it relates to the credit characteristics of the instrument (ie risk of default on the particular instrument). Different instruments issued by the same borrower may have different credit characteristics. In many jurisdictions, liabilities to policyholders rank above most other liabilities: when that is the case, default is less likely for liabilities to policyholders than for other liabilities.

Regulation

H3 In practice, for many regulated insurers, the effect of their own credit standing may be limited, given supervisory procedures that aim to minimise the possibility of losses to policyholders. However, in some cases, the effect may be material. Furthermore, a decline in the *insurer's* credit standing may have little effect on the standing of the *instrument* (the insurance contract). Nevertheless, high quality supervision does not exist in all countries. Furthermore, although direct insurance sold to consumers is often regulated, reinsurance is not always regulated directly. Also, the project applies to all issuers of insurance contracts, not just to regulated insurers.

H4 The rest of this appendix is organised as follows:

(a) As background, paragraphs H5–H7 note that the credit characteristics of debt affect the initial measurement of debt issued for cash.

(b) Paragraphs H8–H12 then discuss whether the credit characteristics of insurance liabilities should affect an initial measurement at current exit value.

(c) Paragraphs H13–H14 discuss whether the subsequent measurement of insurance liabilities should reflect changes in the effects of their credit characteristics.

(d) Paragraph H15 presents the Board's preliminary views on this topic.

(e) Paragraph H16 comments on the implications of guarantees by government or sector guarantee funds.

Initial measurement of debt issued for cash

H5 In most countries, a borrower measures its debt initially at the amount of cash received. IAS 39 leads to a similar result because the initial measurement of the debt is at fair value. In most cases, fair value at that date is assumed to equal the amount of cash received at inception.

H6 For example, suppose Issuer A issues debt of CU1,000, repayable in one year with interest of 6 per cent paid at maturity. Issuer A typically measures the debt initially at the proceeds received (CU1,000). This equals the contractual cash flows (CU1,060) discounted at a rate (6 per cent) that reflects the credit characteristics of the liability. Because it must pay a higher interest rate, a less creditworthy borrower would have received a smaller loan for the same contractual repayment of principal and interest. For example, if a borrower must pay interest at 7 per cent for a comparable one-year loan, it will receive only CU991 for a loan that requires it to repay CU1,060 at maturity.[47] Therefore, the initial measurement reflects the possibility that the borrower may default.

[47] CU1,060 = principal of CU991 plus interest of CU69 (7 per cent of CU991)

That result arises automatically from using the amount of the proceeds received as the initial measurement of liabilities issued for cash.

H7 If Issuer A instead discounted the contractual cash flows (CU1,060) at the risk-free rate (say, 5 per cent), it would recognise at inception a liability of CU1,010, and a loss of CU10. Thus, if the initial measurement of debt excluded the credit characteristics of the debt, a loss would arise at inception from the difference between the risk-free rate and the contractual rate.

Initial measurement of insurance liabilities

H8 Some argue that premium rates do not reflect the insurer's credit standing: if policyholders conclude that an insurer's credit standing exceeds an acceptable minimum level, they are prepared to do business with that insurer. Below that level, policyholders will not do business with the insurer at all. Their willingness to pay a particular level of premiums is not conditional on perceptions of further distinctions in the insurer's credit standing. In other words, supporters of this view argue that premium rates are not particularly sensitive to ratings until the insurer reaches a 'ratings cliff'.

H9 Others argue that premium rates differ observably for insurers with different credit standings. Some perceive that these effects are stronger in some countries or markets (eg corporate markets) than in others. Some argue that insurers with a lower claims paying rating can achieve the same premium rates as higher rated insurers, but may have to spend more on marketing, distribution and servicing to attract and retain policyholders, or may have to include additional terms in apparently similar contracts.

Credit characteristics and current exit value

H10 For the following reasons, in the Board's preliminary view, the current exit value of a liability is the price for a transfer that reflects the credit characteristics of the liability, ie a price that neither improves nor impairs the credit characteristics of the liability:

(a) A creditor would not generally permit the debtor to transfer its obligations to another party of *lower* credit-standing.[48]

(b) A transferee of *higher* credit standing would not assume the obligations for an amount that implicitly requires the transferee to pay interest at a higher rate: if it can borrow at 5 per cent, why would it pay 6 per cent? To induce the transferee to assume the obligation, the transferor would, in effect, have to buy a credit upgrade. But that credit upgrade does not benefit the transferor, so the transferor has no motive to pay for it.

Initial measurement of insurance liabilities and credit characteristics

H11 Even if the credit characteristics of an insurance liability affect premiums or current exit value in principle, some argue that the initial measurement of an insurance liability should not reflect its credit characteristics. They argue as follows:

(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 any other assumption would be contrary to public policy. Although similar considerations apply to all entities, this is particularly sensitive for insurers because of the need to protect policyholders.

(b) Adjustments for credit characteristics are irrelevant if an insurer cannot realise them by transferring the obligations to another party.

(c) Insurers cannot exit from their liabilities except through settlement with the policyholder. If they try to do so in a manner that reflects their credit standing, then they generally violate laws that cover

[48] For simplicity, the rest of this appendix describes an entity as having lower or higher credit standing if its credit standing differs sufficiently to cause a measurable effect on the price that market participants would require. Because of features such as priority, guarantees and collateral, the credit characteristics of some contracts may be relatively insensitive to small gradations in the credit standing of the issuer.

unfair trade practices. Therefore, the actual exit price for an insurer's liabilities cannot reflect its credit standing.

(d) Explicit estimates would be needed to *exclude* the effect of credit characteristics from the measurement of a traded instrument. However, for a non-traded instrument such as an insurance contract, explicit estimates are needed to *include* that effect. Those explicit estimates might be subjective, especially if not calibrated to the actual premium charged. Therefore, it might be best to exclude them from the measurement.

(e) The credit characteristics of a liability depend on the creditworthiness of the issuer, which is specific to that entity. This entity-specific input may be inconsistent with a measurement that reflects the price that market participants would require.

H12 Others give the following arguments for including the credit characteristics of an insurance liability in the initial measurement of the liability:

(a) 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.

(b) As noted above, 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.

(c) 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).

(d) 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.

(e) Paragraph H11(e) reports a view that the credit characteristics of a liability are an entity-specific factor that does not affect the price required by market participants. However, as paragraph H10 explains, current exit value necessarily reflects a transfer to another entity whose credit standing neither improves nor impairs the credit characteristics of the liability. Thus, the original issuer's credit standing is not an entity-specific input in the measurement, but a screen to identify the pool of potential transferees.

Subsequent measurement

H13 Some give the following additional arguments for not accounting for *changes* in the effects of credit characteristics of liabilities[49] in general, and insurance liabilities in particular:

(a) If an insurer's reported insurance liabilities decline with an impairment of their credit characteristics, users may find it harder to assess the insurer's solvency by comparing the carrying amount of its assets with the carrying amount of its liabilities.

(b) A decline in an insurer's credit standing would normally occur at the same time as a loss in the value of an unrecognised asset—internally generated goodwill. Because that loss in value is not recognised as an expense, it would be misleading to recognise income relating to the effect on the liabilities.

(c) If income is recognised when the credit characteristics of liabilities change, that amount will, if there is no default, ultimately be reversed as an expense in later periods.

(d) It would be misleading to report a gain when there is a deterioration in the credit characteristics of liabilities, because an insurer cannot typically realise that gain while it is a going concern.

H14 Proponents of including the effects of the credit characteristics of the liabilities argue the following:

[49] In this appendix, *changes in credit characteristics* refers to changes in the possibility of default or to changes in the price for possible default, rather than to changes in contractual terms.

(a) Consider an entity that has two liabilities that require identical contractual cash outflows but were incurred at different times when the entity's credit standing was different. If measurement ignores changes in the effects of the credit characteristics, the entity will measure the liabilities at different amounts, even though they are economically identical.

(b) A measurement model is inconsistent if it includes the credit characteristics of liabilities at inception but ignores them later.

(c) 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.

Summary of the Board's preliminary views on credit characteristics of insurance liabilities

H15 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 the effect of those credit characteristics. 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.

Policyholder protection mechanisms

H16 In some countries, some policyholder liabilities are guaranteed by government or sector guarantee funds. The IASB and FASB plan to publish a due process document on financial instruments by January 2008. As part of that work, the Board has discussed how debtors should measure guaranteed liabilities. The Board has tentatively decided that:

(a) a third-party contractual guarantee does not affect the measurement of a liability by a debtor if the guarantee does not affect the future obligations of the debtor.

(b) a liability should include any measurement effect arising from the regulatory environment within which the debtor operates, for example statutory deposit insurance.

Glossary of Terms

Appendix I
Glossary

This appendix lists terms that are used in a defined sense in this paper. For these terms, the glossary states the paragraph number of the first or main use of the term in this paper, or notes that the definition is from IFRS 4 *Insurance Contracts* or the *Framework.*

accounting mismatch	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. For example, an accounting mismatch arises if fixed-interest financial assets are carried at fair value but related insurance liabilities are carried on a basis that does not reflect current interest rates.	177
acquisition costs	Costs to sell, underwrite and initiate a new insurance contract.	161
adverse selection	A tendency for new or continuing policyholders to be drawn disproportionately from higher-risk groups because policyholders hold private information that makes higher-risk groups more likely to buy insurance, or to select a contractual option.	18(f)
asset	A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	*Framework*
beneficial policyholder behaviour	A policyholder's exercise of a contractual option in a way that generates net economic benefits for the insurer.	127
cedant	The policyholder under a reinsurance contract.	IFRS 4
claims liability	The liability to pay valid claims for insured events that have already occurred, including claims incurred but not reported (IBNR).	21
claims period	The period when the insured events have occurred but the ultimate payment is still uncertain.	20
constructive obligation	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.	247
current estimate approach	An approach that uses all currently available information in making estimates.	45
current exit value	The amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity.	93
deposit component	A contractual feature that results in a repayment to policyholders, either individually or collectively. (IFRS 4 contains a different definition: a contractual component that is not accounted for as a derivative under IAS 39 and would be within the scope of IAS 39 if it were a separate instrument.)	300

deposit floor	An informal name for the constraint that the measurement of a liability should not be less than the amount repayable (discounted from the date when repayment could be required).	134(c)
deposit premium	The implicit or explicit part of the premium that pays for a deposit component.	300
distributable amount	The amount available for distribution to participating policyholders.	242
economic mismatch	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.	177
entity-specific cash flows	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.	56
embedded value	The present value of estimated profit that will flow to an insurer from its existing contracts.	105
European embedded value (EEV)	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 EEV 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 EEV. [This definition is from the CFO Forum's *European Embedded Value Principles*. Items in italics are also defined in those principles.]	105
expected value	The estimated probability-weighted average of all possible outcomes.	39
expected present value	The estimated probability-weighted average, across all outcomes, of the present value of future cash flows.	39
fair value (existing definition)	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.	IAS 39 and other IFRSs
fair value (possible new definition)	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.	104
Framework	The IASB's *Framework for the Preparation and Presentation of Financial Statements*.	
general account	An insurer's assets, other than **separate account** assets.	269
guaranteed benefits	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.	IFRS 4
guaranteed insurability	A right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.	154
IBNR (claims incurred but not reported)	Claims for insured events that have occurred but have not yet been reported to the insurer.	E24(a) of appendix E
index-linked benefits	Benefits that are contractually linked to an index of asset values, when the insurer (or other issuer) is not contractually required to hold the underlying assets.	287

insurance asset	An insurer's net contractual rights under an insurance contract.	IFRS 4
insurance contract	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.	IFRS 4
insurance liability	An insurer's net contractual obligations under an insurance contract.	IFRS 4
insurance risk	Risk, other than financial risk, transferred from the holder of a contract to the issuer. The definition of financial risk is in IFRS 4.	IFRS 4
insurer	The party that has an obligation under an insurance contract to compensate a policyholder if an insured event occurs.	IFRS 4
intrinsic value (of an option)	The difference between (a) the fair value of the underlying item that the writer of the option must deliver or accept if the holder exercises the option and (b) the price that the holder must pay to exercise the option.	42
investment contract	Informal name for a contract that is within the scope of IAS 39 because it does not transfer significant insurance risk.	233
liability	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.	*Framework*
liability adequacy test	A test to determine whether the carrying amount of a liability needs to be increased, based on a review of future cash flows. (The equivalent, for a liability, of an impairment test for an asset.)	54
'lock in' approach	An approach that freezes estimates that were made at inception and, except for a liability adequacy test, ignores information that becomes available later.	44
measurement attribute (of an asset or liability)	The attribute used to measure an asset or liability in the financial statements (for example, cost, depreciated cost, current exit value or fair value).	92
obligation	A duty or responsibility to act or perform in a certain way as a consequence of a binding contract or statutory requirement or from normal business practice, custom or a desire to maintain good business relations or act in an equitable manner.	*Framework*
participating contract	An insurance contract or financial instrument giving 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.	236
policyholder dividends	Distributions of policyholder surplus to individual policyholders. 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 and distribution.	242
policyholder	A party that has a right to compensation under an insurance contract if an insured event occurs.	IFRS 4
policyholder participation right	A policyholder's right to participate in favourable contract performance.	236
portfolio-specific cash flows	Cash flows that depend on the characteristics of the liabilities being measured. **Portfolio**-specific cash flows need not be **entity**-specific.	57
policyholder surplus	The cumulative amount allocated to policyholders as a class but not yet distributed to individual policyholders.	242
pre-claims liability	The obligation under an existing contract to stand ready to pay valid claims if future insured events arise during the unexpired portion of risk coverage.	21

pre-claims period	The coverage period when the insurer is standing ready to meet valid claims.	20
present value	The value today of a future cash flow, after adjusting for the time value of money. Conceptually, present value also incorporates a risk margin. However, for ease of discussion, this paper refers to present value before risk margins, and deals with risk margins as a separate component of the measurement.	63
recognition	The process of incorporating an item in the balance sheet or income statement.	*Framework*
reinsurance asset	A cedant's net contractual rights under a reinsurance contract.	IFRS 4
reinsurance contract	An insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant.	IFRS 4
risk margin	An explicit and unbiased measurement of the compensation that entities demand for bearing risk.	72
separate account	The pool of assets whose price determines unit-linked benefits.	269
service margin	An explicit and unbiased measurement of the compensation that entities demand for providing services other than the bearing of risk.	87
shortfall	A loss recognised as a result of a liability adequacy test.	54
stand-ready obligation	An obligation to stand ready to transfer cash, or other economic resources, if a specified event occurs.	21
time value of money	The fact that the value of a cash flow depends on the date of its receipt or payment.	63
time value of an option	The part of an option's value that arises because the option may be in the money at expiry.	42
unbundling	Accounting for the components of a contract as if they were separate contracts.	IFRS 4 and 223
unfavourable policyholder behaviour	A policyholder's exercise of a contractual option in a way that generates a net economic loss for the insurer.	127
unit-linked benefit	A policyholder benefit determined by reference to 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).	269
unit-linked contract	A contract for which some or all policyholder benefits are unit-linked.	269
universal life contract	A life insurance contract that allows the policyholder, within specified limits, to vary premiums and the extent of coverage. The contract operates with an explicit policyholder account. The insurer adds explicit interest to the policyholder account, and deducts explicit charges from that account for insurance coverage and for services provided.	262