



**IASB
Insurance Contracts Project**

Field Testing Instructions

Date: Sept 2009

A. Introduction

Thank you for taking part in field testing the proposals for Phase II of the Insurance Contracts Project currently being discussed by the IASB and FASB. Whilst the IASB is conducting this activity, we shall be sharing information with the FASB project team and involving them in conference calls. We shall treat any information you provide to us as part of this exercise in the strictest confidence.

Through field testing we aim to:

- understand how the proposed approach will change current practice
- identify where more detailed implementation guidance may be required
- evaluate the costs and benefits of the proposed approach.

The field testing will be targeted on specific issues as they are identified and prioritized by the project team. We plan to carry out an initial round of testing before publication of an exposure draft (ED), planned for December 2009.

We may wish to seek your help with a second round of testing during the comment period. We appreciate that this will be a busy period for many of you with year end reporting commitments and understand that you may have limited resources for field testing during this period.

B. Field Test Instructions

These instructions are intended to assist participants in preparing their submissions to the IASB on the field testing of the Insurance Contracts proposals.

Timing

You will see from the high level timetable below that we have an extremely narrow window for field testing before the planned publication date of the ED. For round 1 of the testing we will indicate on the questionnaires the date by which we would like you to submit your results. Results for the final test are to be submitted by the **middle of November** to allow us to present our findings to the boards and consider them in finalising the ED.

We shall determine the timing and nature and extent of any additional field testing (round 2) at a later date.

Activity	Date
Individual conference calls with Participants and Project Team	Sept 2009
IASB / FASB Decision expected on measurement approach	Sept /Oct
Field Testing (Round 1) –initial topics	Sept - Nov
Final results submitted (Round 1)	Mid Nov
Publication of Exposure draft	End Dec 09
Follow up session (Round 1) with participants	Feb 2010
Round 2	Feb – June
ED Comment Period ending	June
Follow up session (Round 2) with participants	August
Final Standard	Mid-2011
Effective date	2013?

Field Test Design

We do not propose carrying out a comprehensive field test. In round 1 of this field testing activity we will ask to look at specific topics (examples that we have identified so far are included below). If possible, and where appropriate, we would like you to apply your own tests to support your conclusions using your internal modelling techniques. We will not distribute any prescribed formats or actuarial spreadsheets. Our focus is on ensuring that you are able to apply the principles in the proposals.

For example, your test output may, where appropriate, incorporate a bridging analysis which reflects how you have mapped your local GAAP to the accounting treatment under the new IASB/FASB proposals. Any quantitative output should ideally be supported by a qualitative assessment of whether the new proposals are workable, using information that is currently available or that can be created. As part of this, we would also welcome specific comments about the incremental costs and benefits of moving to the new approach and any obstacles you have encountered in applying the proposed approach.

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We expect that some participants may have more experience in some areas than others and this may result in more / or less testing to assess the effect of the proposals. We request that you vary the level of testing required accordingly.

Due to the current (dynamic) status of the proposals we expect to distribute updated (revised) instructions during the exercise regarding additional information we would like you to prepare.

Topics

Assigning topics

To save time and ensure that we get coverage of as many topics as possible, we may ask different participants to test different topics at the same time. Evidently the topics you are assigned will reflect the nature of the insurance business you carry out.

However, wherever possible each topic will be allocated and distributed to at least **3 insurers** to ensure comparability in the range of results. If you have a strong preference for any particular topic please let us know in the conference call.

Each topic should be evaluated across a number of product lines in order to highlight differences / anomalies in the results for products with differing durations / features. For each product line evaluated, the impact should be determined for a) a “new business” cohort, and b) existing in-force business.

Possible topics identified so far...

1. Treatment of acquisition costs
2. Discounting liabilities
3. Margins including risk margins
4. Features of participating contracts and adjustable universal life contracts
5. Effects of policy holder behaviour including “boundaries of the contract”
6. Investment contracts
7. Unbundling - FAS 97 deposit accounting under US GAAP
8. Other application issues of the measurement approach, eg asset / liability mismatch issue
9. Presentation and disclosure issues
10. UPR (short term contracts)–permitted or required?
11. Unit linked –on / off balance sheet?

Possible product lines

1. Traditional life [TL]
2. Participating and pass through contracts (such as unit-linked) [PT]
3. Guarantee products – such as payout annuities [GP]
4. Property & Casualty products [P&C]
5. Longer duration products – such as long term care/disability [LTC]
6. Universal variable life [UVL]
7. Health Insurance [HI]

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8. Group Life [GL]
9. Group Health [GH]

Possible allocation of topics by product line

Topic	Product line
1. Determination of discount rates	TL, LTC, P&C
2. Determination of risk margins	All
3. Treatment of acquisition costs	GP, PT, GL, TL
4. Features of participating contracts and UL contracts	PT
5. Effects of policyholder behaviour and “boundaries” of contract	UVL, GH, P&C, LTC
6. Investment contracts	PT, GP
7. Unbundling – FAS 97	PT, GP
8. Other application issues	All
a. Mismatch of assets / liabilities	
9. Presentation & disclosure issues	All
10. UPR	Short-term
11. On / off BS	Unit-linked

Field Test output

Observable and measurable output, supported by qualitative assessment

Where practicable we would like you to provide observable and measurable evidence, based on real experience to support your conclusions.

In some instances, to ensure a valid result, field testing of a particular topic may require the insurer to incorporate all components / building blocks of the measurement approach. It is important for participants to remember that the testing is intended to highlight the impact of the particular topic being evaluated. It will therefore be necessary to provide for the particular measurement approach under evaluation:

- additional sensitivity analysis and / or scenarios
- information about alternative methods of estimation
- analysis of implementation challenges such as where inconsistent interpretation and application may arise.

To ensure consistency of results across insurance organisations and product lines, generic assumptions for the remaining measurement features not being tested should be stated explicitly and should be consistent across all entities / products where possible.

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Cost-benefit considerations

We will ask you to provide an assessment of both costs (both one-time and ongoing) and benefits of implementing the proposals.

Costs may include:

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

Benefits associated with a new standard may include:

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

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

Consistency of results

For some topics it will be critical that we ensure consistency of the field test output so as to be able to compare and evaluate the results across the insurers taking part. Whilst we do not intend to distribute prescribed formats and the level of detailed needed will depend on the particular issue being tested, the output for each topic should contain, at minimum, the following components:

- **Overview of product** (description), business purpose for selling / managing the product.
- **Summary of the financial impact** of the particular measurement approach [eg financial impacts table, with supporting commentary]
- **Sensitivity analysis** including range of outcomes under reasonably determinable ranges as well as “tail events” or extreme scenarios.
- **Source of data** including a list of key assumptions made.
- **Narrative description** of the output, analysis/interpretation of results and whether it provides relevant information to users of financial statements.
- **Implementation considerations:**

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- i. Cost / benefit considerations (see above)
- ii. Overall practicability and feasibility issues
- iii. Potential implications for systems and / or financial reporting processes
- iv. Necessity of supplemental application guidance to ensure consistency of application/interpretation.

Incorporating other experience

In order to minimise cost, your field testing should ideally incorporate as much information as possible that is already available to you or readily obtainable. Such information may include:

- Information gained through participation in field tests organised by regulators, such as Quantitative Impact Studies (QIS) carried out for Solvency II (particularly for European participants).
- Information generated by studies or field tests carried out by actuarial bodies, such as the Society of Actuaries (SOA), or trade associations.
- Experience gained in developing and utilising internal models such as those used for Embedded Value.
- Relevant experience gained from your local GAAP.

Confidentiality

We shall treat your field test results in the strictest confidence. We will not release any data from individual participants to parties other than staff and Board members of the IASB and FASB. Any information we release publicly about the results of the field tests will not enable readers to identify data about individual participants.

If participants consent, we shall release publicly the names of companies participating in the testing.

Any questions

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

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C. Background Information

Where are the IASB and FASB now?

The IASB and FASB last discussed the Insurance Contracts project at their individual and joint meetings in July 2009. The boards believe that the best model is one that uses the 'three building blocks' approach to the measurement of an insurance contract.

Both boards agree on the fundamental principles in steps 1 and 2 of the approach, including the requirement to re-measure at every reporting date to include the most up to date information (avoiding the 'locking-in' of assumptions at inception).

The IASB also agreed that when the measurement of the liability on day one exceeds the amount of premium paid (onerous contract), the loss should be reflected through the income statement.

The boards have different views on the treatment of acquisition costs and the nature and purpose of the margin.

IASB

Measurement

The IASB Board is currently considering 2 measurement approaches:

- an updated IAS 37 model
- a current fulfilment value with composite margin.

Neither approach allows for day 1 gains. Thus the initial measurement of the overall margin would be determined by reference to the premium. To implement either approach, an insurer would use the building block approach described in the discussion paper (DP) *Preliminary Views on Insurance Contracts* issued by the IASB in May 2007.

The Board has also tentatively decided to require the unearned premium model for the pre-claims liability of short duration insurance contracts as a simplification of the building block approach.

Updated IAS 37 model

The IAS 37 model is a settlement model that relies on prices from an active market if a relevant market exists and a fulfilment model if it doesn't. It therefore incorporates a three building block approach. The model would have to be modified to fit contractual obligations.

The IAS 37 model currently covers non-contractual liabilities, for example litigation. The measurement of the liability is expressed as:

The amount the entity would rationally pay at the report date to be relieved of the present obligation.

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The measurement approach for IAS 37 is currently being developed. Details are currently being ironed out as to how this model could apply this measurement objective to an insurance contract. At this stage we can conclude that it would include a residual margin.

Measurement, including a discussion of the updated IAS 37 model, is due to be discussed at the September meeting.

Other decisions

The Board has decided tentatively:

- to include in the measurement of insurance contracts the expected cash flows resulting from those contracts, including those cash flows that depend on whether policyholders exercise options in a contract.
- to distinguish existing contracts from new contracts by looking at the insurer's ability to cancel the contract or change the pricing or other terms.
- to recognise revenue to the extent of acquisition costs incurred at initial recognition, limited for this purpose to the incremental costs of issuing (that is selling, underwriting and initiating an insurance contract).

FASB

Measurement

The FASB has tentatively decided that:

- the objective of the liability measurement is to report a value on the basis of the insurer's fulfilment of its contractual obligations to its policyholders over time.
- the expected cash flows in the measurement of an insurance liability should be discounted to reflect the time value of money and that the cash flows and discount rate should be updated each reporting period.
- the fulfilment value should include only a composite margin with no explicit risk margin.
- an insurer should recognise all acquisition costs as an expense when incurred and should not recognise any revenue (or income) at inception to offset those costs incurred.

When will a decision be made on the measurement approach?

A decision on the measurement approach is expected to be made by the IASB in September with a view to further discussion with the FASB in its next Joint Board Meeting on 26-28 October 2009.

D. Other Sources of Information

The following may provide useful background for the field testing exercise. It is not a definitive list.

IASB/FASB

Measurement approach -the three building blocks

Irrespective of which measurement attribute the boards decide to adopt, the three building block approach to the estimation of liabilities as featured in the IASB's DP *Preliminary Views on Insurance Contracts* is pertinent for insurance contracts. The building blocks are:

- 1 the undiscounted probability-weighted estimate of future cash flows (appendix E to the DP contains draft guidance on this, although it was written with current exit value in mind. An updated version of this appears in the observer note for the IASB's meeting in March 2009 ([click here](#))).
- 2 the effect of the time value of money (paragraphs 69 and 70 of the DP discuss this, although with current exit value in mind.)
- 3 a margin or margins. (appendix F to the DP contains draft guidance on this, although it was written with current exit value in mind.)

The IASB / FASB July 2009 Observer Notes 11A and 11C provide the most up to date analysis of the different measurement approaches that are currently being considered by the boards. These are available along with audio files of Board discussions on the [Insurance Contracts](#) project webpage. Observer notes of other Board meetings are also available on the webpage. Throughout the field testing period we shall keep you up to date with any developments on the measurement approach as the boards continue their deliberations.

Society of Actuaries (SOA)

Findings published by the SOA (Society of Actuaries) as a result of their field testing of new business (final results tentatively scheduled for December 2009).

Previous SOA study – Society of Actuaries' *Research Project on Financial Reporting for Insurance Contracts under Possible Future International Accounting Standards published January 2008 with illustrative results* (in the Actuarial Practice Forum, August 2008).

International Actuarial Association (IAA)

IAA *Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins*. (April 2009)

***Committee of European Insurance and Occupational Pensions Supervisors
(CEIOPS)***

Consultation Paper 42 discusses cost of capital method of risk margins for current Solvency II proposal. This method may or may not be relevant for the phase II approach.

U.S. GAAP

U.S. GAAP for Life Insurers, edited by Tom Herget (Society of Actuaries).

SFAS 60 (traditional life and non-life insurance, DAC)¹

SFAS 97 (limited pay traditional life insurance, universal life and investment contracts)

SFAS 113 (reinsurance)

SFAS 120 and SOP 95-1 (traditional participating contracts)

SFAS 163 (financial guarantee insurance contracts)

SOP 03-1 (for certain non-traditional long-duration contracts and separate accounts).

¹ These references are pre-U.S. GAAP codification.