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Board

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Insurance Contracts (Phase II)

Project Updates are provided for the information and convenience of constituents who wish to follow the IASB's deliberations. All conclusions reported are tentative and may be changed at future IASB meetings. Decisions become final only after completion of a formal ballot to issue an International Financial Reporting Standard, Interpretation, or Exposure Draft.

Introduction

This project report is structured as follows:

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Objective

1. The objective of this project is to develop an IFRS on accounting for insurance contracts. The project will address accounting by both insurers and policyholders.

Next Steps

2. The Board is working towards a Discussion Paper, with publication expected in the first quarter of 2007. An exposure draft will take at least 18 months from then, and a final standard will take at least another 12 months.

Background

Introduction

3. This is a summary of phase II of the Board's project on insurance contracts. The Board completed phase I in March 2004 by issuing IFRS 4 *Insurance Contracts*. See the Insurance Contracts project page on www.iasb.org for links to
 - a summary of IFRS 4
 - Frequently Asked Questions on the content and development of IFRS 4.
4. The Board suspended work on phase II in early 2003, and restarted phase II in mid 2004. On restarting phase II, the Board took a fresh look at financial reporting by insurers. Past work by the Board and by its predecessor was a useful resource, but did not bind the Board.
5. To advise it on the project, the Board formed an Insurance Working Group, made up of senior financial executives, analysts, actuaries, auditors and regulators. See the Insurance Contracts project page on www.iasb.org for a list of participants. The Insurance Working Group has held eight two-day meetings, starting in September 2004. The most recent meeting was in June 2006.
6. There are important interactions with other projects, particularly those on the conceptual framework, revenue recognition, accounting measurement, performance reporting, financial instruments and revisions to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and a potential project on liabilities and equity. The work on insurance contracts will proceed in parallel with these other projects and will

not wait for their outcome. This work may generate useful inputs for those other projects.

Convergence

7. An important priority for the IASB is seeking convergence with national standards, especially US GAAP. The US Financial Accounting Standard Board (FASB) plans to issue an Invitation to Comment containing the IASB discussion paper. The FASB will consider 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.
8. Some current and recent FASB projects address limited aspects of accounting for insurance contracts:
 - In its project on risk transfer in insurance and reinsurance contracts, the FASB is developing a definition of insurance contracts and exploring simplified approaches to bifurcating insurance contracts. In May 2006, the FASB published an *Invitation to Comment on Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*. The IASB staff expects that the IASB's Discussion Paper:
 - will consider whether some or all insurance contracts should be unbundled (bifurcated). IFRS 4 requires unbundling in some cases and permits, but does not require, it in others.
 - will not review the IASB's existing definition of an insurance contract in IFRS 4 and related guidance. The IASB staff does not view work on this definition as a high priority. Nevertheless, the staff will monitor the FASB's work in this area and assess the implications for phase II.
 - The FASB is reviewing the measurement of financial guarantee insurance contracts. The IASB staff will monitor the FASB's work in this area.
 - In March 2006, the FASB issued an FASB staff position on *Accounting for Life Settlement Contracts by Third-Party Investors*. A life settlement occurs when an individual sells his or her life insurance contract to a third party who intends to continue paying the premiums on the contract. The scope of the IASB's project includes accounting by holders of insurance contracts (including both the original policyholder and a transferee), but the IASB will not address this topic until after the discussion paper.

Tentative Conclusions to Date

9. The Board's tentative conclusions apply to all types of insurance contract: life and non-life, direct insurance and reinsurance. They also apply throughout the life cycle of a contract, through 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). The following paragraphs summarise the preliminary views that the Board expects to include in the Discussion Paper:

- Recognition and derecognition (paragraph 10)
- Measurement (paragraphs 11-35)
- Future premiums and policyholder behaviour (paragraphs 36-37)
- Policyholder participation (paragraphs 38-41)
- Assets held by insurers (paragraph 42-44)
- Changes in insurance liabilities (paragraph 45)
- Investment contracts (paragraph 46)

Recognition and derecognition

10. An insurer should:

- recognise rights and obligations created by an insurance contract when it becomes a party to the contract.
- derecognise an insurance liability (or a part of an insurance liability) when, and only when, it is extinguished—ie when the contractual obligation is discharged or cancelled or expires.

Measurement

Three building blocks for measuring insurance liabilities

11. In measuring its insurance liabilities, an insurer should use the following three building blocks:

- current unbiased probability-weighted estimates of future cash flows (paragraphs 13-17)
- current market discount rates that adjust the estimated future cash flows for the time value of money (paragraph 18)
- 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) (paragraphs 19-23)

12. All three building blocks use current information. In the Board's view, this will provide several benefits to users of an insurer's financial statements:
- more relevant information about the amount, timing and uncertainty of future cash flows arising from existing insurance contracts. Because insurance liabilities transfer risk and many of them have long durations, such information is particularly important.
 - a consistent approach to favourable changes in estimates. In most existing approaches, an insurer recognises only:
 - some favourable changes (implicitly by offsetting them against adverse changes occurring at the same time)
 - some unfavourable changes (if they exhaust any implicit margins that existed at inception, or offset favourable changes at the same time).
 - a coherent framework to resolve emerging issues without resorting to unprincipled distinctions and arbitrary new rules.
 - consistency with other IFRSs that already require current estimates of future cash flows in measuring non-financial liabilities (see IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) and financial liabilities (see IAS 39 *Financial Instruments: Recognition and Measurement*).
 - less (and perhaps no) need to separate embedded derivatives.
 - less (and perhaps no) need for anti-abuse rules to prevent selective recognition of previously unrecognised economic gains through reinsurance.
 - less (and perhaps no) need for arbitrary criteria to distinguish amendments to an existing contract from new contracts.
 - margins that are explicit rather than implicit.
 - clear reporting of economic mismatches between insurance liabilities and related assets, without accounting mismatches that have concerned many in phase I.

Current estimates of future cash flows

13. Insurers already estimate future cash flows for some aspects of many existing accounting approaches and many insurers already use cash flow estimates as one factor in pricing decisions. Nevertheless, a current value approach would place more demands on estimates of cash flows than most existing approaches, particularly for longer duration contracts, because changes in estimated cash flows would affect profit or loss at once.
14. Commentators sometimes object to proposals for current estimates on the grounds that it is not useful to conform all estimates at once to the most recent actual experience. However, these objections rest on a misunderstanding. For example, suppose that mortality last year was 20 per cent worse than previous experience and

previous expectations. Several factors could have caused that sudden 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
 - identifiable non-recurring causes.
15. An insurer would typically investigate why experience changed 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 would be that the expected present value of the cash flows increases, but by less than 20%. 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 significantly above previous estimates, the estimated probability of high-mortality scenarios would increase over time.
16. Estimates of the probabilities for each scenario should faithfully represent conditions at the reporting date, not past conditions. However, it is also important to consider whether changes in estimates faithfully represent changes in conditions during the period. For example, if estimates were at one end of a reasonable range at the beginning of the period and conditions have not changed, moving to the other end of the range would not faithfully represent what has happened during the period.
17. To the extent possible, estimates should be consistent with observed market prices:
- Some estimates relate to observable market variables, such as interest rates. An insurer should use these variables as direct inputs without adjustment.
 - Other estimates relate to variables (such as mortality) that cannot, in general, be observed directly from market prices and transactions. These estimates:
 - should be reviewed every year and updated if they are no longer consistent with all available information about current conditions.
 - should not contradict observable market variables. For example, an assumption about future inflation rates should be within a range that is consistent with expectations implied by market interest rates.
 - should not incorporate the effect of synergies with other assets and liabilities. For example, if an insurer is significantly more or less efficient than other market participants, its estimates of cash flows should not reflect its own efficiencies or inefficiencies.

Discount rates

18. Discount rates should:

- be consistent with observable market prices for cash flows whose characteristics match those of the insurance liability. Those characteristics include timing, currency and liquidity.
- exclude any factors that influence observed interest rates but are not relevant to the liability (for example, risks that affect the observed rate but are not present in the liability).

Estimating the margin

19. As explained above, one input in measuring an insurance liability is a margin. In the view of several Board members, an insurer should calibrate the margin at inception to the price observed in the transaction with the policyholder: thus an insurer would not recognise a net gain at inception.
20. However, in the view of a majority of Board members, although the observed transaction price serves as a useful reasonableness check on the initial measurement of the insurance liability, that price should not override an unbiased estimate of the margin another party would require if it took over the insurer's contractual rights and obligations.
21. The Board does not intend to prescribe specific methods for determining margins, but does intend to give some guidance on characteristics that a margin would need to have.
22. Some other initiatives may lead to useful inputs for guidance on risk margins. The International Actuarial Association (IAA) has set up a Risk Margin Working Group. Several supervisors have been developing ideas on risk margins for solvency, for example in the European Solvency 2 project. Several insurers have been developing thoughts on risk margins for solvency and for internal economical capital projects.
23. Many insurance contracts require an insurer to provide services in addition to the service of bearing risk. For example, many unit-linked contracts require the insurer to provide investment management services. An investment manager would not commit to provide investment management services without an adequate fee. Similarly, within the context of an insurance contract, an insurer would not willingly provide those services free. Thus, the measurement of an insurance liability should include a service margin if market participants typically require such a margin. This has the following implications:
 - If the contract explicitly or implicitly provides the fee that market participants typically require, the insurer recognises an asset and measures it at the amount of the origination costs that market participants typically incur.
 - If market participants typically require a higher explicit or implicit service fee, the initial measurement of the asset is less than the origination costs that market participants typically incur. In extreme cases, this measurement is negative, in which case the insurer recognises a liability. In this respect, the measurement differs from traditional discounted cash flow measurements, which do not typically generate a negative number for a positive future net cash flow.
 - When the insurer renders the related service in later periods, it releases the service margin and recognises revenue. The revenue is the margin that market

participants would require, not the margin that is implicit or explicit in the contract. In this respect, the revenue differs from the revenue recognised under IAS 18 *Revenue*.

- If it becomes clear during the life of that contract that market participants would require a higher service margin than previously estimated, the measurement of the liability increases.
- The inclusion of a service margin is an important difference between the approach favoured by the Board and embedded value approaches.

Current exit value

24. The above discussion identifies three building blocks. A concise name for a measurement that uses them is 'current exit value'. Current exit value is the amount the insurer would expect to have to pay now if it transferred all its remaining contractual rights and obligations to another entity.
25. Typically, the current exit value of an insurance liability is not observable, so it must be estimated using the three building blocks described above.
26. It is too early to conclude whether current exit value means the same as fair value. The Board will review that question as the Board works on its fair value measurement project. For that project, the Board intends to issue soon a discussion paper containing FASB Statement 157 *Fair Value Measurements*. A fair value measurement of an insurance liability would typically fall on level 3 of the hierarchy in Statement 157.
27. In proposing a measurement of insurance liabilities at current exit value, the Board does not intend to imply that an insurer can, will or should actually 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 Board's aim is to provide useful information that will help users make economic decisions.

Other measurement issues

28. Comments follow on other aspects of measurement:
 - Portfolio basis of measurement (paragraphs 29-30)
 - Acquisition costs (paragraph 31)
 - Reinsurance assets (paragraph 32)
 - Unearned premium as an approximation to current exit value (paragraph 33)
 - Unbundling (paragraphs 34)
 - Credit characteristics of insurance liabilities (paragraphs 35)

Portfolio basis of measurement

29. 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 measurement does not affect the expected present value of future cash flows. Moreover, unbiased estimates of cash flows reflect all relevant inputs, whether those inputs are derived by contract or in aggregate.
30. 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.
 - should not reflect benefits, if any, of diversification between portfolios and of negative correlation between portfolios.

Acquisition costs

31. Insurers incur costs to sell, underwrite, and initiate a new insurance contract (acquisition costs). Suppose an insurer charges the policyholder CU¹ 90 for the insurance coverage and CU 10 for the insurer's acquisition costs. From the policyholder's perspective, it paid CU 100 for the insurance cover and has an asset of CU 100. However, in the Board's view the insurer does not have a liability of CU 100 and an intangible asset of CU 10; rather, it has a liability of CU 90. The insurer would recognise the acquisition costs of CU 10 as an expense, and would recognise income of CU 10.

Reinsurance assets

32. Reinsurance assets should be measured at current exit value. Unlike the incurred loss model used today in IFRS 4 (and in IAS 39), current exit value uses an expected loss model. This incorporates reductions for:
- the expected (probability-weighted) present value of losses from default or disputes, and
 - the margin that market participants would require to compensate them for bearing the risk that defaults or disputes exceed expected value.

Unearned premium as an approximation to current exit value

33. An insurance contract obliges the insurer to stand ready to pay valid claims for future insured events arising under the existing contract. Many existing models for non-life insurance measure that obligation by reference to the unearned part of the premium received (combined with a liability adequacy test). The result may sometimes be

¹ CU = currency unit

close to current exit value if the pattern of risk is linear, the contract is not likely to be highly profitable or highly unprofitable, and circumstances have not changed significantly since inception. However, the Board does not intend to permit insurers to use unearned premium when it differs materially from current exit value.

Unbundling

34. For recognition and measurement, an insurer should not unbundle insurance, deposit and service components of insurance contracts if the components are so interdependent that the components can be measured only on an arbitrary basis. In all other cases, an insurer should unbundle them. For presentation, the discussion paper will discuss, without expressing a preliminary view, whether an insurer should:
- present all premiums as revenue, all premiums as deposit receipts, or some premiums as revenue and some premiums as deposit receipts.
 - split premiums for some or all insurance contracts into a revenue component and a deposit component.

Credit characteristics of insurance liabilities

35. The current exit value of a liability reflects its credit characteristics. An insurer should disclose their effect and changes, if any, in their effect.

Future premiums and policyholder behaviour

36. For many regular premium contracts, the policyholder can cancel the contract before paying all premiums. For some categories of policyholders, the payment of extra premiums will result in extra net cash flows from the insurer (for example, for groups of life policyholders with severely impaired health). There is no doubt that the measurement of the insurance liability needs to include the extra net cash outflows that will result.
37. However, in other cases, the insurer expects to benefit if policyholders continue paying premiums. This is typically the case for most policyholders in the early years of many life insurance contracts. These cases are more problematic. The insurer expects most policyholders to continue paying. Policyholders also expect to continue paying, unless their circumstances change. Nevertheless, the insurer cannot compel the policyholder to continue paying premiums. The Board has reached the following tentative conclusions for these cases:
- The insurer has an asset relating to the future premiums that the policyholder must make to retain a right to guaranteed insurability (less additional benefits that result from those premiums). Guaranteed insurability refers to a right that permits continued coverage at a price that is contractually constrained, without reconfirmation of the policyholder's risk profile.
 - Conceptually, that asset is best viewed as a part of a customer relationship, not as a contractual right.

- When the insurer becomes a party to the contract, the insurer should recognise that part of the customer relationship (but not the rest of the customer relationship relating to future contracts).
- The insurer should measure that part of the customer relationship and the related liability in the same way, and should present them together. Although the customer relationship is conceptually separate from the contractual rights and contractual obligations, separate recognition and measurement would be impracticable and, arguably, not useful.

Policyholder participation

38. Participating (with profits) contracts entitle the policyholder to benefit from favourable performance of a group of contracts and/or related assets. The benefits may take several forms, including cash and additional insurance cover. Insurers sometimes describe those benefits as dividend or bonus. The insurer has some discretion over whether, how and when it allocates the benefits to policyholders collectively and as individuals, but there are often constraints over that discretion.
39. The Board has tentatively concluded that policyholder participation rights create a liability when the insurer has an unconditional obligation to transfer economic benefits to policyholders, current or future. More specifically:
- A policyholder participation right creates a liability if it legally or equivalently compels potential outflows of cash or other economic resources. This is consistent with the Board's thinking in its project to revise IAS 37 and in the joint project with the FASB on the conceptual framework. An obligation may be enforceable in various ways, including legal action or intervention by a regulator.
 - An insurer may feel economically compelled to pay bonuses to policyholders for competitive reasons. However, mere economic compulsion does not create a liability.
 - If policyholders have a collective prior claim on the surplus, that prior claim does not, in itself, create an obligation. However, an insurer should disclose the fact that part of its equity is subject to those prior claims.
 - A dividend scale approved by the regulator creates an obligation. The staff will investigate whether the insurer should measure that obligation using the dividend scale currently in force, or develop estimates of the dividend scale that would apply in each cash flow scenario.
 - If no unconditional obligation exists, an insurer should not recognise a liability for expected transfers of economic benefits to policyholders. If an unconditional obligation arises later, the insurer should recognise the resulting liability and an expense then.
 - Policyholder participation rights should not be regarded as the equity component of a hybrid contract (similar to convertible debt). Accordingly, none of the premium should be regarded as proceeds received for issuing an equity instrument. The staff will investigate:

- whether the face of the balance sheet should distinguish equity attributable to policyholders from equity attributable to shareholders
- whether the face of the income statement should distinguish profit or loss attributable to policyholders from profit or loss attributable to shareholders.
- Identical requirements should apply to shareholder-owned insurers and mutuals.
- Participation rights in investment contracts should be treated in the same way as participation rights in insurance contracts.

Universal life contracts

40. Within specified limits, universal life insurance contracts allow the policyholder to vary premiums and allow the insurer to vary charges to policyholders. The Board has discussed these contracts, focusing on the proposed test for including future premiums (ie guaranteed insurability), the classification (as a liability or as equity) of crediting rates that exceed the minimum that can be contractually required and the interaction of crediting rates with estimates of lapses. The staff will investigate these issues further.
41. Some view universal life contracts as a form of participating contract, because the insurer's approach to crediting rights etc is likely to depend on the performance of the contracts, as well as on competitive factors for new business.

Assets held by insurers

42. The Board does not expect this project to change existing IFRSs (eg IAS 39) for assets held by insurers (except possibly in some cases where the liability cash flows are contractually determined by the assets, as discussed in paragraph 43).

Assets held by insurers: Unit-linked contracts

43. Unit-linked (variable) contracts pass on investment performance to policyholders in much the same way as a mutual fund. Typically, the underlying assets are measured at fair value and the same measurement is used for the related part of the liability. Problems may arise in three main areas:
- Should the insurer consolidate the pool of assets? This is a matter for the Board's work on consolidations generally.
 - What happens if the insurer cannot classify some assets at fair value through profit or loss? This occurs if the pool of assets includes treasury shares (the insurer's own shares, which are not assets of the insurer), owner-occupied property (eg an office building held in the pool of assets as an investment but rented to the insurer for its own operations) or goodwill in a subsidiary. The Board would prefer to eliminate the resulting effects on profit or loss and equity, but eliminating them might create unacceptable inconsistencies with other requirements of IFRSs. The discussion paper will examine possible approaches, such as adjusting the measurement of the assets or liability, but will not express a preliminary view.

- Some unit-linked contracts do not transfer significant insurance risk. At present, IFRSs defer the part of the incremental acquisition costs relating to the provision of future investment management services. Should the Board change this approach to conform it to the Board's approach to acquisition costs for insurance contracts? The discussion paper will review this issue, but not express a preliminary view.

Assets held by insurers: Index-linked contracts

44. Some contracts link the benefit amount directly to an index but do not require the issuer to hold the assets underlying the index. 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. The Board does not intend to introduce exceptions to normal recognition and measurement criteria for those assets or the related liabilities.

Changes in insurance liabilities

45. The discussion paper will discuss approaches to presenting and disclosing the components of changes in insurance liabilities, but will not propose specific requirements. The project on presentation of financial statements will be relevant.

Investment contracts

46. Many insurers issue some contracts that are within the scope of IAS 39 because they do not transfer significant insurance risk. The discussion paper will:
- document differences between the Board's tentative conclusions for insurance contracts and existing requirements in IAS 39 and IAS 18 *Revenue*.
 - present the Board's preliminary view that it would be preferable to eliminate those differences, but the discussion paper will not make specific proposals.

Contact information

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