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**International
Accounting Standards
Board**

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **February 2008, London**

Project: **Insurance Contracts**

Subject: **Overview of comments (Agenda paper 2A)**

Purpose of this paper

1. This paper gives a high-level overview of the responses to the Discussion Paper *Preliminary Views on Insurance Contracts*. We will provide more detail on the responses as we discuss individual subjects at later meetings. This paper is intended as an input to the process of setting priorities for work over the next few months. It does not provide enough information to support decisions on technical issues.
2. We published the discussion paper on 3 May 2007, with a comment deadline of 16 November 2007. We received 158 responses.

Introduction

3. Respondents commented that a new standard to replace IFRS 4 *Insurance Contracts* is needed urgently.
4. This paper deals with the following:
 - (a) Three building blocks (paragraphs 5- 9)

- (b) Measurement attribute (paragraphs 10-15)
- (c) Policyholder behaviour and future premiums (paragraphs 16-18)
- (d) Participating contracts (paragraphs 19-22)
- (e) Performance reporting (paragraphs 23-26)
- (f) Other issues (paragraphs 27-42)
- (g) Timetable and process (paragraphs 43-49)
- (h) Interaction with other projects (paragraph 50)

Three building blocks

5. Respondents generally agreed that the three building blocks discussed in the paper provided a useful framework for thinking about the measurement of insurance liabilities, though virtually all respondents had significant concerns about important aspects of the building blocks. Some respondents (mainly from the US) suggested building on existing US GAAP for insurers.
6. Respondents largely supported the following main aspects of the building blocks:
 - (a) using current estimates of cash flows, rather than locked in estimates. The effects of changes in estimates would be recognised immediately in profit or loss.
 - (b) consistency with observable market prices for factors such as interest rates and equity prices
 - (c) using expected value (ie probability-weighted average) rather than a single outcome. Some respondents expressed concerns about using expected value. Although these concerns were sometimes expressed in terms of disagreement with the principle, many of the concerns seemed to arise mainly from concerns about how this principle would be applied in practice.
 - (d) reflecting the time value of money (though as noted in paragraph 7(e), some disagree with this for non-life insurance).

(e) including a risk margin, and recognising income in line with the release from risk.

7. Nevertheless, virtually all respondents had concerns about one, and usually more, significant aspects of the building blocks:

(a) There were several views on whether it would be acceptable to recognise a net profit (ie after acquisition costs) at inception:

(i) Respondents were divided (as was the Board) on whether it would be acceptable to recognise a net profit (ie after acquisition costs) at inception.

(ii) The discussion paper took the position that net profits at inception would be rare, except perhaps in some niche markets. Some respondents believed that net profits at inception would be common and significant.

(iii) Some suggested that any net profit arising at inception should not be recognised immediately in profit or loss, but should instead be recognised separately (either as a separate liability or through other comprehensive income) and subsequently recognised in profit or loss in line with the release from risk or as other services are provided. In some suggestions, the insurer would also recalibrate those margins in specified circumstances when estimated cash flows change (such recalibration would reduce the net effect on profit or loss at the time of the change in estimated cash flows).

(iv) Many respondents asked the Board to clarify how the approach to revenue recognition in this project relates to the approach in IAS 18 *Revenue* and the two approaches the Board is considering in the revenue recognition project.

(b) In relation to risk margins:

(i) Respondents generally agreed that the carrying amount of insurance liabilities should include a risk margin, but most respondents wanted more information on how to estimate risk margins. Many were also concerned about the lack of observable benchmarks for risk margins.

(ii) Some advocated narrowing the range of acceptable methods for estimating risk margins, though many also agreed that it would be essential for the guidance to

remain based on principles. Several suggested that bodies such as the International Actuarial Association (IAA) should provide more detailed guidance to support high level principles in the IFRS.

(iii) Some argued that the carrying amount of insurance liabilities should include the cost of bearing risk (for example, the cost of holding the necessary capital), but should not include any further profit that the insurer, or another entity, would require for bearing that risk.

(iv) Most agree that the risk margin should provide a measure of the remaining risk and should not be used simply as a shock absorber.

(c) Most respondents did not understand the rationale for the service margin described in the discussion paper and several said that the *Frequently Asked Questions* posted by the staff on the web site in October 2007 had not provided sufficient clarification. Some respondents saw the service margin as an attempt to provide a ‘plug’ that provides more continuity with the approach to revenue recognition in IAS 18. Most respondents commented that users would not benefit from a separation of risk margin from service margin. Some respondents suggested that estimated cash flows should be based on the costs of outsourcing the services, in which case a separate service margin would be redundant.

(d) The discussion paper proposes that estimates of cash flows should be consistent with the cash flows that market participants would face. Respondents generally agreed with this to the extent that cash flows are determined by observable financial market prices, such as interest rates and traded equity prices. The discussion paper also argued that, in practice, market participant cash flows relating to underlying insurance claims would not differ from entity-specific cash flows. Most respondents also seemed to accept this argument, at least implicitly. However, many respondents objected to using estimates of the expenses that market participants would incur, rather than entity-specific expenses. In this context, ‘expenses’ refers to the costs of administering insurance contracts during their lives, rather than cost of the underlying claims. Respondents put forward the following arguments:

- (i) Given that most insurance liabilities will not, and cannot, be transferred, entity-specific expenses are more relevant to users than the expenses that market participants would incur.
- (ii) It is often not possible to observe directly what expenses market participants would incur. Moreover, any apparent differences between those expenses and entity-specific expenses may arise from subtle and perhaps undetectable differences between the portfolios of, and products provided by the entity and the product and portfolios of other market participants. Thus, estimates of market participants' expenses may be less robust than the entity's estimates of its own expenses.
- (iii) It would be unreasonable to require insurers to go to exceptional lengths to demonstrate that their own cash flows are in line with the market. Moreover, it may be difficult to persuade auditors and regulators that the insurer has done enough work to confirm that its expenses are in line with those incurred by other market participants.
- (iv) Insurers price contracts by reference to their own expected cash flows. Thus, a measurement based on market-participant cash flows could lead to a gain or loss at inception, which would reverse in later periods as the insurer provides the services.
- (e) Some respondents opposed the introduction of discounting and risk margins for non-life insurance contracts. They suggested retaining the existing approach [(i) unearned premium combined with a liability adequacy test for pre-claims liabilities and (ii) undiscounted estimates of cash flows, with no explicit margin for claims liabilities]. Other respondents generally favoured discounting and risk margins for these contracts.
- (f) Most respondents vigorously opposed the proposal that the carrying amount of insurance liabilities should reflect the credit characteristics of those liabilities. A few took the opposite position, preferring to maintain consistency with the definition of current exit value and with IAS 39 *Financial Instruments: Recognition and Measurement*.

- (g) Most respondents agreed that the discount rate for non-participating liabilities should reflect the characteristics of the liabilities, not those of the assets backing those liabilities. A few respondents argued for asset-based rates. They argued that this would:
- (i) be consistent with common pricing practice.
 - (ii) avoid recognising large losses at inception for contracts that are expected (on an expected value basis) to be profitable.
- (h) Many respondents argued that the discussion paper artificially constrained the cash flows by excluding (i) some future premiums and other aspects of policyholder behaviour and (ii) some expected payments to participating policyholders. Later sections of this paper deal with these topics separately.
8. Some respondents suggested that it would not always be necessary, or perhaps even desirable, to separate the three building blocks rigorously. They indicated that the objective should be to focus on the overall measurement, rather than the individual components.
9. The discussion paper included a working draft of proposed guidance on cash flows (appendix E), risk margins (appendix F) and discount rates (paragraph 66). Views were mixed on whether this was at the right level of detail. Also, some respondents questioned whether the guidance struck the right balance between consistency with the underlying principles and practical implementation. Many respondents emphasised the importance of a principles-based approach.

Measurement attribute

10. The discussion paper proposed that insurance liabilities would be measured at current exit value. Some respondents supported that proposal. However, many suggested that the Board explore a notion tied more directly to the fact that insurers generally expect to settle their liabilities over time by paying benefits to policyholders as the benefits fall due, rather than transfer their liabilities to a third party.
11. Supporters of such a settlement value appeared to have three main objections to current exit value:

- (a) Current exit value requires the insurer to use market-consistent cash flows, rather than entity-specific cash flows. For reasons discussed in paragraph 7(d), many respondents would prefer to entity-specific cash flows.
 - (b) The discussion paper concludes that current exit value reflects the credit characteristics of the liability. Some respondents agreed with this conclusion, while others disagreed. Most respondents, including many of those who agreed with that conclusion, opposed a measurement that reflects the credit characteristics of the liability.
 - (c) Some respondents suggested that, although current exit value might often be very close to settlement value in practice, and perhaps even the same amount, current exit value is the wrong objective for items that will not be, and often cannot be, transferred.
12. Respondents did not generally suggest precise definitions of a measurement attribute that corresponds exactly to the notion of settlement over time. Suggestions included:
- (a) Current ultimate settlement value, current performance value or current extinguishment value
 - (b) Current value assuming an orderly settlement of the rights and obligations over time by the reporting entity
 - (c) Entity-specific ultimate settlement value, defined as the present value of the amount that would be required to meet the contractual obligations to policyholders in the ordinary course of business over time, including an entity-specific required margin to perform the tasks necessary to settle the obligation.
 - (d) The estimated price for a transfer to another insurer that is identical in all respects.
13. Some respondents stated explicitly, and others implied, that it would be sufficient to use appropriate building blocks and that aligning those building blocks with an explicit measurement attribute would be unnecessary.
14. Some respondents supported current exit value, but asked the Board to focus more on the characteristics of the 'reference entity' that is the assumed transferee. Some suggested a highly rated well-diversified insurer, and indicated that specifying such an entity could be

helpful in dealing with issues such as the unit of account (whether diversification between portfolios should affect measurement) and credit characteristics of liabilities.

15. Many respondents suggested that measurement should focus on the contract as a whole, rather than on those individual elements of contracts that meet the definitions of assets and liabilities. They asserted that this would be more consistent with the selection of current exit value as measurement attribute, on the basis that market participants would, in assessing the price for a transfer of the contract, consider all cash flows arising from the contract. They indicated that this view would resolve issues relating to policyholder behaviour and future premiums (paragraph 16-18 below) and policyholder participation (paragraph 19-22), as well as dealing with interdependencies between future premiums and policyholder participation.

Policyholder behaviour and future premiums

16. For many life insurance contracts, policyholders pay regular premiums. Typically, the insurer cannot force the policyholder to continue paying premiums, though contracts often create economic incentives that encourage policyholders to continue paying. The discussion paper analysed such contracts as creating three distinct sets of cash flows:
 - (a) Those cash flows that will occur if the policyholder pays no more premiums. For example, in a regular premium life insurance contract, the insurer must pay death benefits arising from deaths in the current month if the policyholder has already paid the premium for this month. Clearly, the measurement of the liability would reflect all these cash flows (with a small adjustment for estimated surrenders during the current month).
 - (b) The additional net cash **outflows** that arise that will arise from future premiums under contracts that have become onerous. In example 7 in appendix G of the discussion paper, this would occur for policyholders who have become unhealthy. It is uncontroversial that the measurement of the insurance liability should include additional net cash outflows for the contracts that have become onerous.
 - (c) Those additional net cash **inflows** that arise that will arise from those contracts that are not onerous. In example 7 of the discussion paper, this would occur for policyholders who are still healthy. The discussion paper proposed that the insurer should include

these cash flows if they pass a guaranteed insurability test. The discussion paper analysed these cash flows as relating to (part of) a customer relationship, rather than as contractual cash flows. However, for practical reasons the discussion paper proposed that the insurer would combine those cash flows for recognition measurement and presentation purposes with the cash flows identified in (a) and (b), so the practical effect would be the same as including them in the measurement of the liability.

17. The treatment of the cash flows in (a) and (b) seems uncontroversial in general.

However, many respondents opposed the guaranteed insurability test for the cash flows in (c). They argued as follows:

- (a) Once a contract meets the recognition criteria, an insurer should recognise that contract as a single asset or liability, without dividing the contract into components for separate recognition.
- (b) A measurement that excludes the cash flows in (c) would not be current exit value, because market participants would consider all the cash flows in (a), (b) and (c) in determining an acceptable price for a transfer of the insurer's rights and obligations under the contract.
- (c) The guaranteed insurability test would be difficult and burdensome.
- (d) The guaranteed insurability test relies on a distinction that insurers would not find useful internally. It excludes net cash inflows that most respondents regard as part of the cash flows from the contract. Particular problems may arise for more flexible contract designs that enable participants to vary or suspend premiums.
- (e) A few respondents felt the guaranteed insurability test might include too many cash inflows. These respondents fell into the following categories:
 - (i) Health insurers currently using an annual accounting model for multi-year contracts with features such as annual rate-setting constrained by government, portability of coverage to other insurers and restrictions on setting differential rates for different policyholders or on rejecting new policyholders.

- (ii) Non-insurers concerned about the implications for other contracts if non-enforceable cash flows are included.

18. Respondents generally agreed that the objective should be to measure existing contracts, without considering cash flows from possible future contracts. Respondents did not generally suggest how to distinguish existing contracts from possible future contracts, though some acknowledged that this distinction may be difficult to make and could need further work.

Participating contracts

19. The discussion paper proposed that, for participating contracts, the cash flows for each scenario should include an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date. Some respondents felt this test could provide an appropriate answer in their circumstances (though not necessarily in other environments), but reported concerns that the financial liabilities project (to amend IAS 37) might narrow the definition of a constructive obligation to the point where it would not deliver an appropriate answer for them.

20. However, most respondents indicated that the measurement of a participating insurance contract should include all cash flows from the contract, without any distinction between the participating and non-participating elements. Few respondents commented explicitly on whether this approach would be equally appropriate for both mutuals and non-mutuals.

21. Some UK respondents asked the Board to address the 'inherited estate'. This term describes amounts that have accumulated over many decades in participating funds and whose 'ownership' may not be attributable definitively between shareholders and policyholders.

22. In phase II, investment contracts with a discretionary participation feature are in the scope of IFRS 4, rather than IAS 39. Many respondents suggested that this would remain appropriate in phase II.

Performance reporting

23. The discussion paper discussed whether premiums should be treated as premiums, as deposits, or as a mixture of revenue and deposits, but did not put forward specific proposals on this topic. Most respondents viewed all premiums as revenue, especially for non-life contracts. Some saw merit in a margin presentation, particularly for life contracts. Others proposed retaining a revenue presentation in the performance statement, supplementing this with a margin analysis in the notes, especially for life contracts.
24. The discussion paper considered in general terms how changes in insurance liabilities might be disaggregated in the performance statement, but made no specific proposals. Most respondents did not provide specific suggestions, though several emphasised that any requirements should use principles rather than detailed rules. Most suggestions provided were based on existing practice. Some suggested that the disaggregation should be designed to be coherent with the three building blocks, or to reflect differences in the quality of inputs (for example, by distinguishing the effects of observable inputs from the effects of unobservable inputs).
25. Most agreed that all changes in insurance liabilities should be reported in profit or loss. Some proposed permitting or requiring insurers to use other comprehensive income (OCI) for changes in insurance liabilities to avoid accounting mismatches if insurers use the available-for-sale (AFS) category for financial assets held to back insurance contracts. Proponents of this view argued that, if this were not done, insurers would find themselves, in effect, unable to use AFS. Some also expressed concerns about volatility. Advocates of using OCI did not generally discuss whether the gains and losses would be recycled from OCI when the liability is derecognised.
26. Many commentators indicated that they found it difficult to comment on measurement without being given a clearer picture of how the performance reporting would work.

Other issues

Recognition

27. The discussion paper proposed that an insurer should recognise insurance contracts when it became a party to the contract. Respondents expressed two types of concern about this:

- (a) Some viewed insurance contracts as service contracts, but felt that the discussion paper's approach to recognition was consistent with a view that insurance contracts are financial instruments. Those respondents preferred to treat insurance contracts as fully executory until the coverage period begins. Under that approach, until the coverage period begins, the insurer would treat any premium received as a deposit, with a liability adequacy test applied if the contract were onerous. Some noted that IAS 39 allows settlement date accounting in some cases.
- (b) Many felt that recognising the contracts at inception would lead to practical issues of data collection and that the cost of doing so would exceed any benefits.

Unit of account

- 28. Most agreed that the measurement of insurance liabilities should reflect diversification **within** a portfolio of insurance contracts. Views differed on the proposed definition of a portfolio.
- 29. Views were also mixed on whether the measurement should reflect diversification **between** portfolios. Some referred to cases when an insurer's pricing reflects its own diversification: excluding that diversification effect from the measurement would lead to gains or losses at inception that would subsequently reverse.
- 30. Some suggested that the current exit value of a portfolio would reflect the level of diversification available to the transferee. They suggested that the natural transferee to consider is well-diversified and, therefore, that current exit value should reflect the diversification within a well-diversified transferee (the reference entity), but not the actual diversification present within the entity that has the liability at the reporting date. Some also suggested that insurers lack of diversification by buying reinsurance as a substitute.

Assets backing insurance contracts

- 31. Respondents generally agreed that it would be desirable to eliminate accounting mismatches that arise if the assets of a unit-linked fund are not recognised (eg treasury shares) or are not carried at fair value through profit or loss (owner occupied property and investments in subsidiaries). Most of those commenting favoured permitting or requiring the insurer to carry all assets of a unit-linked fund at fair value through profit or loss,

rather than adjusting the carrying amount of the liability. Some respondents indicated that similar mismatches could arise for participating contracts. Some also referred to particular practical difficulties for contracts that permit policyholders to switch between more or less freely between participating, non-participating and unit-linked funds (sometimes called ‘multi-support’ funds).

32. Some respondents suggested a broader principle that insurers should be required to carry all assets backing insurance contracts (participating and non-participating) at fair value through profit or loss. Some asked the Board to remove constraints on the use of the fair value option in IAS 39.
33. IFRS 4 *Insurance Contracts* permits insurers to redesignate financial assets as at fair value through profit or loss when they change accounting policies for insurance liabilities. This enables insurers to avoid creating accounting mismatches if they switch to current value approaches for insurance liabilities. Many respondents urged the Board to permit a similar option on transition to the phase II standard.

Acquisition costs (agree to expense, if solution found for future premiums)

34. Respondents generally agreed that acquisition costs should be recognised as an expense when incurred, if the measurement reflects all future cash flows from which acquisition costs would be expected to be recovered.
35. As noted above, some respondents favoured an unearned premium approach for the pre-claims period of non-life insurance contracts. Some of those respondents preferred to recognise acquisition costs as (the cost of) an intangible asset, to be amortised in line with the recognition of premium revenue.

Unbundling

36. The discussion paper proposed that the following treatment for insurance contracts containing both an insurance component and a deposit component:
 - (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 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.
- (c) 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.

37. Respondents agreed with (a) but many respondents disagreed with (b). They argued that:

- (a) the resulting measurement of the insurance component as a residual would not be a faithful representation and would not provide useful information to users.
- (b) splitting the measurement in this way would be costly.
- (c) the terms *interdependent* and *arbitrary* are unclear, so there would be variation in practice.

38. Some respondents agreed with unbundling in the cases described in paragraph 36(c), for conceptual and practical reasons. Others opposed unbundling (ie splitting contracts into components) in all cases.

Tax

39. Several respondents suggested that anomalies may arise if careful consideration is not given to tax effects. Some also suggest that presentational difficulties may arise from taxes that are, in substance, taxes on policyholders.

Inconsistencies with IAS 39 / IAS 18

40. Appendix B of the discussion paper gave a high level summary of differences between the model proposed in the discussion paper and the approaches used in IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 18 *Revenue*. In response:

- (a) Some respondents suggested amending IAS 39 for some or all financial liabilities. In this respect, the most common suggestion was to eliminate the deposit floor (the stipulation 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 that the payment could be required). Some respondents suggested that the surrender value of an insurance contract should not be equated with a demand deposit, for various reasons, including the fact that surrender 'kills' the benefit of insurability.

- (b) Some respondents suggested that IAS 39 should not be amended in this project. They felt that any changes would need to be considered in a wider context, with input from a wider constituency.
- (c) Some suggested that service components of insurance contracts should be unbundled and IAS 18 applied to those components.

Reinsurance assets

- 41. Some respondents agreed that an expected loss approach for defaults and disputes would be consistent with the expected cash flow approach in general and with a current exit value model in particular. Others preferred to retain an incurred loss model, partly because insurers typically deal with only a small number of reinsurers.

Business combinations and portfolio transfers

- 42. IFRS 4 permits an expanded presentation for insurance contracts acquired in a business combination. Respondents generally agreed that the need for this would disappear if the Board ultimately retains current exit value as the measurement attribute and concludes that it is the same as fair value as described in IFRS 3 *Business Combinations*. Respondents generally felt unable to comment on what would be appropriate if the Board ultimately reaches a different position. Some requested further guidance on the difference between business combinations and portfolio transfers.

Timetable and process

- 43. Some respondents expressed concerns that the Board should not use this project as a testing ground for radical ideas that the Board might not adopt more widely. Others were concerned that the Board might adopt new ideas in this project without a wider debate and then prejudice conclusions in other projects.

44. Some respondents believed that it would be appropriate for this project to become a joint project with the FASB. Others expressed concerns that FASB involvement might slow the project down.
45. Many respondents urged the Board to carry out field tests before adopting new accounting approaches.
46. European respondents generally asked the Board to try to reach conclusions consistent with the likely conclusions of the European regulators' Solvency 2 project. They also urged the Board to complete the project in a timely fashion to enable European insurers to adopt phase II and Solvency 2 at about the same time.
47. More generally, many respondents argued that a phase II standard is needed urgently. At the same time, respondents recognised that there are difficult issues to resolve and acknowledged that the Board needs to take enough time to reach the right answers in the context of both this project and existing and possible future requirements for other areas of accounting.
48. Some respondents suggested that policyholder accounting is not a priority and argued that the Board should not deal with it now if doing so would delay the urgently needed standard for insurers.
49. A few respondents asked the Board to hold roundtables at this stage, or to consider other means of involving constituents in the process.

Interaction with other projects

50. Many respondents stressed the need to ensure that this project is co-ordinated with other projects, particularly revenue recognition. Other projects mentioned included non-financial liabilities (revision of IAS 37), liabilities and equity, the conceptual framework, presentation of financial statements, fair value measurements, financial instruments and pensions. One suggestion was that the Board should consider seeking interim input from the public on cross-cutting issues that affect several projects, rather than dealing with them separately in individual projects.