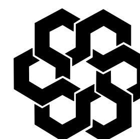

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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 2009, London**
Project:	**Insurance Contracts**
Subject:	**Nature of insurance contracts (Agenda paper 10D)**

Purpose of this paper

1. This paper provides a high-level discussion of three aspects that are relevant for the general approach of the insurance project. This paper is intended to provide background in support of agenda paper 10A. We do not seek decisions on specific technical issues.

2. The rest of this paper deals with:

   (a) the nature of insurance contracts (paragraphs 3-18)

   (b) unbundling (paragraphs 19-24)

   (c) a separate insurance standard (paragraphs 25-29)

The nature of an insurance contract

The question

3. How should an insurance contract be characterised? Financial instruments or service contracts? Or maybe something else? Some believe that, conceptually, these questions need to be answered before any decisions on a measurement approach can be made.

However, the nature of an insurance contract has also proven to be a difficult question to answer. Respondents have a wide range of views on this, which has been reconfirmed by the positions expressed in the comment letters to the discussion paper *Preliminary Views on Insurance Contracts* (DP).

4. Insurance contracts may include characteristics that on a stand-alone basis would be classified as financial instruments or service contracts. Arguably a 'third' characteristic can be identified within an insurance contract: an insurance element that reflects the risk coverage. However, some think that this element could also be classified as either a financial instrument or a service contract.

5. We broadly identified five views:

   (i) insurance contracts are financial instruments

   (ii) insurance contracts are service contracts

   (iii) some insurance contracts are financial instruments, others are service contracts

   (iv) insurance contracts are a 'third' class of contracts that may also bear characteristics of financial instruments and/or service contracts

   (v) Insurance contracts are constructed of financial instrument components, service components and, arguably, an insurance component (a 'third' component).

6. Those who believe that insurance contracts are financial instruments refer to the financing arrangements within insurance contracts, although this element generally is quite small for short-term insurance contracts and is also found within many contracts in other industries. Some also view insurance contracts as a form of option (the policyholder has the right to put the damaged item to the insurer in exchange for a payment, in cash or kind, that makes good part or all of the loss). However, some contracts clearly include a service component (eg. asset management service), though this component may not be identifiable from the other components of the contract in a way that is not arbitrary.

7. Those who believe that insurance contracts are service contracts refer to the fact that the insurance company is providing a service to its policyholders by standing ready over the coverage period to meet valid claims (coverage). However, a number of insurance

contracts clearly include a deposit component, though this component may not be separable from the other components of the contract in a way that is not arbitrary.

8. Some believe that the two different views mentioned in the previous paragraphs make it clear that insurance contracts simply cannot be put into one bucket; some contracts would be regarded as financial instruments and other contracts as service contracts. However, this raises the issue where to draw the line; drawing this line will arguably be difficult and may in the end require some arbitrary boundaries. Even if the line could be drawn in a satisfactory way the issue still has not gone away. Insurance contracts that would be classified as financial instruments would arguably still include a servicing element. And insurance contracts that would be classified as service contracts would arguably still include elements of a financial instrument.

9. For that reason, some believe that insurance contracts are a 'third' class of contracts that should be dealt with by a measurement approach that reflects for the specific characteristics of insurance contracts. However, this may result in accounting discontinuities with financial instruments and/or service contracts. At the margins, some insurance contracts are very similar to financial instruments, whereas others are very similar to service contracts.

Do we need an answer to the question on the nature of an insurance contract?

10. Some believe that insurance contracts are constructs of financial instrument components, service components and, arguably, insurance components (paragraph 5(v)). Proponents of this view may take the position that, ideally, the issue of the nature of an insurance contract should be irrelevant. Separating individual insurance contracts into components that bear the characteristics of a financial instrument and service contracts would result in:

    (a) treating services sold as part of an insurance contract in the same way as the same services sold separately.

    (b) treating financial instrument components of an insurance contract in the same way as financial instruments sold separately.

(c) treating insurance components in accordance with an insurance standard [though some believe that a ‘third’ component does not exist and should be classified as either (a) or (b)].

11. The DP referred to this approach as unbundling. However, unbundling causes some challenges [we will come back to unbundling later in the paper]. This means that in some, and perhaps many, cases the insurance contract cannot be unbundled in a straightforward way.

12. One way forward therefore is to explicitly address the issue about the nature of an insurance contract before having a debate on the measurement attribute. During earlier stages of the project, the issue of how to characterise an insurance contract has been debated extensively without coming up with a conclusive answer. The responses to the DP also showed widespread views on this issue. It is not likely that continuing this debate will come up with a useful answer; at least not in the short term. Staff does therefore think that a debate on the nature of an insurance contract will consume considerable time without a clear prospect of a useful outcome.

13. The other way forward is to discuss the measurement approach straightaway. But can the insurance project decide on the measurement model without first having had an explicit debate on the nature of an insurance contract?

14. An important aspect is how much friction there would be between the measurement approach for financial instruments and service contracts:

(a) Service components would be measured based on the revenue recognition model. In their preliminary views on revenue recognition, the boards proposed an allocated transaction price approach for measuring performance obligations from contracts with customers. The DP on insurance contracts took the position that the customer consideration model was 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.

(b) Financial instrument components would be measured based on a standard for financial instruments. This might involve measurement at fair value or amortised cost, a choice between these measurements or fair value in specified cases and amortised cost in

other specified cases. The list of candidates for insurance contracts we have identified does not include amortised cost because applying this model to insurance liabilities would not produce useful information and would involve many complexities and arbitrary features (see paragraph 42 of agenda paper 10A for reasons). A fair value approach would be similar, and perhaps identical, to current exit value, as described in the DP.

15. The measurement model proposed in the discussion paper on revenue recognition and the fair value approach in a standard for financial instruments are arguably difficult to reconcile; many differences exist. This results in the possibility of considerable accounting discontinuities ('bright lines') for insurance contracts with both financial instruments and service contracts.

16. It may be possible not to classify explicitly insurance contracts as either financial instruments or service contracts as long as the measurement model for insurance contracts is sufficiently robust to deal with the resulting accounting discontinuities for the most prominent types of contract. We probably want to consider the following main types of contracts:

(a) property and casualty contracts

(b) whole life contracts

(c) term life contracts

(d) endowment contracts

(e) fixed and variable annuities

(f) universal life contracts (a type of contract that permits considerable flexibility over the premiums paid, amount of coverage bought and charges).

(g) credit insurance

(h) health insurance

(i) reinsurance

17. In agenda paper 10A we argue that insurance contracts should be measured in a way that involves explicit current estimates of cash flows, time value of money and explicit margins. On one hand, such an approach is not necessarily inconsistent with the allocated transaction price in the discussion paper on revenue recognition (provided consistency exists on initial measurement). On the other hand it shares many characteristics of the fair value approach in the financial instruments standards. Arguably, an explicit measurement approach for insurance contracts might mitigate the impact of the accounting discontinuity between financial instruments and service contracts [though it would not eliminate those discontinuities entirely].

18. There probably will always be a number of cases that will put considerable stress on the robustness of the measurement approach; some universal life insurances contracts with significant investment components are likely to be such a case. A principles based approach could provide sufficient flexibility to deal with these cases.

Unbundling

19. The discussion paper considered whether insurance contracts should be unbundled if the contract contains different components that would be subject to different accounting requirements if sold separately. As mentioned earlier (see paragraph 11), unbundling would, in principle and if feasible, avoid accounting discontinuities.

20. However, the individual components of an insurance contract can be closely interrelated and the value of the bundled product may differ from the sum of the individual values of the components. Furthermore, interdependencies may exit between the individual components.

21. The DP therefore proposed 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.

22. Many respondents to the DP highlighted both practical and conceptual problems that could arise from unbundling. Respondents agreed with paragraph 21(a) but many respondents disagreed with paragraph 21(b). They argued that:

(a) the resulting measurement of the insurance component as a residual would not be a faithful representation of that component 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.

23. Some respondents agreed with unbundling in the cases described in paragraph 21(c), for conceptual and practical reasons. Others opposed unbundling (ie splitting contracts into components) in all cases.

24. Because of the difficulties described in paragraph 22 we conclude that unbundling might reduce accounting discontinuities, but is unlikely to provide a comprehensive solution to those discontinuities. We will consider at a future meeting whether unbundling could be applied in some cases.

A separate insurance standard

25. Some believe that insurance should not be a 'special case'. Some of those take the position that this should result in not having a separate insurance standard. Rather, insurance should be dealt with by including it in the scope of other standards. Likely candidates for scoping insurance contracts in are:

(a) a standard on financial instruments.

(b) the future standard on revenue recognition.

26. Bringing insurance in the scope of another standard would result in consistency by applying the same measurement basis; development of a separate standard would then not be required.

27. However, we believe that insurance contracts are most likely to need to be covered by a separate insurance standard:

    (a) arguably, an insurance contract includes a 'third' component that cannot be fully captured by reference to measurement of financial instruments or service contracts. This insurance component may need measurement requirements that deal with some specific aspects.

    (b) a standard on financial instruments or service contracts may not deal with other aspects of insurance like recognition, performance reporting and disclosures.

    (c) the boards still have to decide whether to develop a second measurement approach in the revenue recognition project; the allocated transaction price approach proposed in the revenue recognition discussion paper might provide decision-useful information for some contracts but not all.

28. A separate standard on insurance contracts does not necessarily mean that the measurement approach in that standard would be inconsistent with other measurement models. An insurance standard could apply the measurement principles of another standard in terms of insurance with differences (if any) being based on a clear rationale; this does not necessarily create a 'scope exception' for insurance.

29. We would like to emphasise that in our view:

    (a) applying current exit value, which is similar to fair value applied for financial instruments, does not necessarily lead to the conclusion that insurance contracts are financial instruments. Rather, it would be based on the principle that fair value leads to the most decision useful information in the case of insurance contracts.

    (b) applying a measurement approach that is consistent with revenue recognition to the extent possible does not necessarily lead to the conclusion that insurance contracts are

service contracts. Rather, it works from the principle that insurance should be accounted for in line with other contracts with customers.