Contact(s)	**Alessandro d'Eri**	aderi@iasb.org	+44 (0)20 7246 6495
	Hans van der Veen	hvanderveen@iasb.org	+44 (0)20 7246 6464
	Mark Trench	metrench@fasb.org	+1 (0)203 956 3455
	Jeffrey Cropsey	jdcropsey@fasb.org	+1 (0)203 956 5305

| Project | **Insurance Contracts** |
| Topic | **Business Combinations and Portfolio Transfers** |

Purpose of this paper

1. This paper addresses the measurement of insurance contracts assumed in a business combination on the date of acquisition as well as the measurement of a portfolio of insurance contracts assumed in a transaction other than a business combination (ie portfolio transfer).

Summary of staff recommendations

2. In this paper staff recommend that for insurance contracts assumed in a business combination or a legal transfer of a portfolio:

    (a) an insurer, at the date of acquisition, determines the expected present value of the cash flows [plus the risk adjustment, in the model that uses such an adjustment].

    (b) for insurance contracts assumed in a transaction other than a business combination (ie portfolio transfer), the insurer should compare the amount determined under (a) with the consideration received for those contracts:

         (i) if the consideration received exceeds the amount determined under (a), the insurer should treat the difference as the [residual margin] [composite margin] at that date;

         (ii) if the amount determined under (a) exceeds the consideration received, the insurer should recognise that difference in profit or loss at that date.

(c) For contracts assumed in business combination, the insurer should compare the amount determined under (a) with the fair value of those contracts:

  (i) if the fair value of the contracts exceeds the amount determined under (a), the insurer should treat the difference as the [residual margin] [composite margin] at that date;

  (ii) if the amount determined under (a) exceeds the fair value of the contracts assumed, the insurer should initially measure the contracts assumed at the amount determined under (a), rather than at their fair value. This exception from the general requirement in IFRS 3 *Business Combinations* and ASC Topic 805 *Business Combinations* would increase the initial carrying amount of goodwill recognized in the business combination.

Contracts assumed in a portfolio transfer

3. Portfolios of insurance contracts can be assumed:

   (a) as a legal transfer of a portfolio of insurance contracts (portfolio transfer);

   (b) as part of a business combination.

   In this section we deal with portfolio transfers. We deal with portfolios of contracts assumed in business combinations in paragraphs 12-34.

4. If an insurer were to apply, on the date of the transfer, the proposed measurement model for insurance contracts, it would be able to determine the current components of the building block approach, ie the expected cash flows [and, under a residual margin approach, a risk adjustment], but it would then need a calibration reference point in order to determine the [residual margin] or the [composite margin]. This calibration point could be identified as being the consideration received on the date of the transfer in exchange for assuming the portfolio of insurance contracts.

5. This calibration could result in:

   (a) a nil amount, that is the [residual margin] or the [composite margin] equals zero;

   (b) a positive amount, that is, in effect, the [residual margin] or the [composite margin]; or

   (c) a negative amount.

6. Because, according to the proposed measurement model for insurance contracts, the residual and the composite margins cannot be negative, an entity should recognise the negative amount under (c) as a loss on the date of the transfer and record it in profit or loss.

7. Two highly simplified examples provide a numerical explanation of the approach described above; they consider both cases, positive and negative difference-generating scenarios.

   (a) *Positive difference.*

      (i) Consideration received: CU500.

      (ii) Expected cash flows: CU400.

      (iii) Risk adjustment (for a residual margin model only): CU50.

Table 1

Inputs Description	Residual Margin	Composite Margin
Consideration received	+500	+500
Cash flows	**-400**	**-400**
Risk adjustment	**- 50**	**-**
Residual margin/ composite margin on transfer date	**CU50**	**CU100**

   (b) *Negative difference.*

      (i) Consideration received: CU500.

      (ii) Expected cash flows: CU525.

      (iii) Risk adjustment (for a residual margin model only): CU50.

Table 2

Inputs Description	Residual Margin	Composite Margin
Consideration received	+500	+500
Cash flows	**-525**	**-525**
Risk adjustment	**- 50**	**-**
Recognised loss on transfer date	**(CU75)**	**(CU25)**

8. As shown in table 1, if the consideration received exceeds the current measurement of the portfolio as determined by estimating the cash flows [plus a risk adjustment, under a residual margin approach], the insurer should treat that difference as the [residual margin] [composite margin] at the date of the transfer (in the example, respectively CU50 and CU100).

9. On the other hand, as shown in table 2, if the current measurement results in an amount higher than the consideration received, because the residual and composite margins cannot be negative, then a loss is recognised, respectively of CU75 (under a residual margin approach) and of CU25 (under a composite margin model).

10. Staff believe that this approach is consistent with the proposed measurement model for insurance contracts as it aims at:

    (a) eliminating any gains arising on the date of the transfer, by recording a corresponding residual or composite margin at that date;

    (b) recording in profit or loss on the date of the transfer, any loss that arises on that date as the negative difference between the consideration received and the current measurement component of the proposed building block approach (ie expected cash flows [plus a risk adjustment under a residual margin approach]).

11. Therefore, staff recommend that for insurance contracts assumed in a transaction other than a business combination (ie portfolio transfer), the insurer should compare the amount that results from the determination of the expected present value of the cash flows [plus the risk adjustment, in the model that uses such an adjustment] with the consideration received for those contracts and:

    (a) if the consideration received exceeds the expected cash flows, the insurer should treat the difference as the [residual margin] [composite margin] at that date;

    (b) if the expected cash flows exceed the consideration received, the insurer should recognise that difference in profit or loss at that date.

Question for the boards
Do the boards agree with the staff's recommendations in paragraph 11?

Contracts assumed in a business combination

12. IFRS 3 *Business Combinations* requires an entity to measure assets and liabilities arising from a business combination at fair value. ASC Topic 805 *Business Combinations* has the same requirement. IFRS 4 *Insurance contracts* does not exclude insurance liabilities and assets (and related reinsurance) from that requirement.[1]

13. Although fair value and the proposed model for insurance contracts are both current measures (supplemented with allocation element in the case of the insurance contracts model), in general they consider the measurement from different perspectives; the market-participant view for the former and an entity specific view for the latter. For most inputs, these two views are unlikely to result in differences in practice, for example for financial market variables and also for non-market variables if there is no evidence that market participants would view those non-market variables differently from how the insurer views them. However, some differences are possible:

    (a) Margins determined under the insurance model may differ from the margins a market participant would require. This is particularly true for a residual margin or a composite margin, which is the result of a calibration rather than a direct measurement.

    (b) A fair value measurement includes non-performance risk, but the proposed insurance model includes non-performance only as an implicit part of the residual or composite margin at inception and does not update the measurement for it subsequently.

14. Measuring the insurance contracts assumed at fair value at the date of acquisition and then measuring it subsequently using the proposed insurance contracts model:

    (a) is unlikely to have significant effects for most inputs; but

    (b) would cause a discontinuity for components that are part of fair value, but are not explicitly measured under the insurance contracts measurement, particularly risk adjustments (if a composite margin approach is applied) and non-performance risk. The board would have to determine how to deal with those components.

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[1] However, IFRS 4 permits an expanded presentation of the fair value of assumed insurance contracts into (a) a liability measured in accordance with an insurer's accounting policies for insurance contracts that it issues and (b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). This treatment combines the need to maintain the requirement to measure at fair value the identifiable assets acquired and liabilities assumed, while permitting insurers to continue using existing measurement approaches for insurance liabilities.

15. An alternative would be to (i) determine the fair value under Business Combinations and (ii) determine the expected present value of the cash flows [plus the risk adjustment, in the model that uses such an adjustment] under the insurance contracts model at the date of acquisition, with that outcome being calibrated to the fair value of the contracts assumed at that moment. The rest of the paper discusses how this calibration can be performed :

      (a) Application of the proposed insurance model on the date of acquisition (paragraphs 16-19):

      (b) A simple example (paragraphs 20-28).

      (c) Treatment of losses arising on the date of acquisition (paragraphs 29-34)

      (d) Staff comments and recommendation (paragraphs 35-37).

Application of the proposed insurance model on the acquisition date

16. On the date of acquisition an insurer would need to record the insurance contracts assumed in a business combinations. Particularly, the insurer would apply the building block approach as follows:

      (a) it would determine the current measurement component of the building block approach by estimating the expected present value of future cash flows [and including a risk adjustment, if the boards select a measurement that includes a risk adjustment]; then

      (b) it would need to determine on acquisition date the residual margin or the composite margin.

17. Arguably, the result of the current measurement component of the insurance contracts model will be fairly close to the fair value measurement of the same contract or portfolio of contracts, the main differences being, as pointed out in paragraph 13,

      (a) the own credit risk component, which would not be explicitly measured under the insurance model.

      (b) an explicit risk adjustment, which is not included in the insurance model under a composite margin approach.

18. When determining the calibrated amounts, ie residual and composite margins, the insurer could adopt a practical expedient and use the date of acquisition or transfer as a calibration

point. Therefore the residual or composite margin on the date of acquisition would be the amount that eliminates at that date, the positive difference between:

    (a)   the fair value of the insurance contracts assumed, and

    (b)   the amount resulting from the application of the current measurement component of the building block approach.

19.   However, the difference presented above could also be:

    (a)   nil, in this case no calibration exercise would be needed; or

    (b)   negative, which would imply that a loss arises on acquisition date and is recognized at that date, because the residual or the composite margins cannot be negative..

In the next section we illustrate this by means of a highly simplified numerical example.

A simple example

20.   The fact pattern is the following:

    (a)   Let us consider three possible scenarios: **Green, Blue and Yellow**.

    (b)   In the **Green scenario**, the fair value of the portfolio of insurance contracts assumed in a business combination on the date of acquisition is CU125; in the **Blue scenario** the fair value is CU115; and in the **Yellow scenario** the fair value is CU95.

    (c)   In all three scenarios, the expected present value of future cash flows is CU100 and the risk adjustment is CU20.

21.   An insurer has assumed the portfolio of insurance contracts. At that date, it determines the current measurement component, ie the cash flows plus a risk adjustment, as follows:

    (a)   approach with risk adjustment plus residual margin (100+20)= CU120;

    (b)   approach with a composite margin, CU100.

Table 3

Scenarios	Green		Blue		Yellow	
Inputs Description	Residual Margin	Composite Margin	Residual Margin	Composite Margin	Residual Margin	Composite Margin
Fair Value	+125	+125	+115	+115	+ 95	+ 95
Cash flows:	-100	-100	-100	-100	-100	-100
Risk adjustment	- 20	-	-20	-	-20	-
Residual/composite margin/(negative difference)	**CU5**	**CU25**	**(CU5)**	**CU15**	**(CU25)**	**(CU5)**

22. As shown in table 3, in the **Green scenario**, the result of the first three building blocks is CU120 (for the residual margin approach) and the result of the first two building blocks is CU100 (for the composite margin approach). Compared to the fair value of the portfolio of insurance liabilities assumed (CU125), this would present a **positive difference of CU5** under a **residual margin approach** and a **positive difference of CU25** under a **composite margin approach**. Both differences would be eliminated by recording respectively a residual margin of CU5 and a composite margin of CU25.

23. In the **Blue scenario**, the insurer would compare the fair value of CU115 with the current measurement (CU120 in the residual margin approach and CU100 under the composite margin approach). In this case, under a **residual margin approach** there is a **negative difference of CU5** (115-120). Under a **composite margin approach** there is still a **positive difference of CU15** (115-100) which would then be eliminated by a composite margin recorded for the same amount. We discuss how to deal with the negative difference in paragraphs 29-34.

24. Finally, in the **Yellow scenario** the fair value is CU95, lower than the current measurement in both approaches and, in particular, under a residual margin approach there would be a **negative difference of CU25 (95-120)** and under a composite margin approach the **negative difference would be CU5 (95-100)**. We discuss how to deal with these negative differences in paragraphs 29-34.

25. These differences would have to be determined at the level of an individual portfolio because the subsequent measurement of margins will occur at that level under the insurance contracts model.

26. In order to be consistent with the proposed measurement approach for insurance contracts, an insurer would eliminate any positive differences at the date of acquisition by recognising a residual margin or a composite margin. In that case, the overall measurement at the date of acquisition equals fair value and consists of:

    (a) expected present value of the cash flows [plus the risk adjustment, in the model that uses such an adjustment]; and

    (b) the residual or composite margin as the difference between the fair value and (a).

27. For example, in the Green scenario, in order to be consistent with the proposed measurement approach for insurance contracts, an insurer would eliminate the positive difference arising at the date of acquisition of the contract by recording a residual margin of CU5 (125-120) or a composite margin of CU25 (125-100).

28. However neither a residual nor a composite margin can be negative. The next section analyses how to deal with negative differences arising on the date of acquisition or transfer.

Treatment of losses arising on the date of acquisition

29. If a negative difference arises on the date of acquisition of a insurance contract, it could be:

    (a) recognized directly, for its entire amount, in profit or loss; or

    (b) treated as a measurement exception in the context of a business combination.

30. Under the proposed insurance measurement model, a negative difference on day one would be recognised in profit or loss immediately (alternative (a)). Staff believe that this negative difference is attributable to a measurement discontinuity arising from the change of perspective between a fair value measurement (market participant's view) and the proposed insurance contracts measurement (entity-specific view). Conceptually, one aspect that helps explain this difference is the own-credit risk component which is taken into account when determining the fair value, but it is excluded from the proposed measurement for insurance contracts.

31. The alternative under (b) is to provide an exception to IFRS 3 *Business Combinations* and ASC Topic 805 *Business Combinations*. Such an exception would consist of measuring the insurance contracts assumed in a business combination under the proposed insurance contracts model if that would result in a higher amount than fair value. The negative

difference arising between these two approaches would then be implicitly recorded as a component of goodwill.

32. IFRS 3 already includes a conceptually similar exception, although applied to a different measurement model. For example, paragraph 26 of IFRS 3 requires that the liabilities and assets related to the acquiree's employee benefit arrangements are measured under the approach provided for IAS 19 *Employee Benefits* rather than under IFRS 3.

33. Here follows one example based on the fact pattern of the **Yellow Scenario** in paragraph 24, slightly expanded to determine the amount of goodwill. The example provides a numerical explanation of the approach considered in the paragraph 31 (the example is developed considering both a residual margin approach and a composite margin approach):

Under a residual margin approach

(a) **Total consideration transferred CU305.**

(b) Fair value of insurance liabilities assumed by the acquirer, CU95 (we assume that the only liability here is the insurance liability transferred);

(c) Acquisition-date amounts of identifiable assets acquired, CU350;

(d) Acquisition-date amounts of identifiable liabilities assumed, (100+20) = **CU120** (this is **not** the fair value of the liability [CU95], but the result of the application of the current component of the building block approach, ie discounted, unbiased, probability weighted cash flows and the risk adjustment).

(e) Based on the fact pattern presented above, the calculation of the goodwill would be the excess of:

(i) the total consideration transferred, CU305; over

(ii) the net of the acquisition date amounts of identifiable assets acquired and of identifiable liabilities assumed, (350-95)= CU255.

(iii) Goodwill is (305-255) = CU50.

(f) However, because the fair value of the insurance liabilities assumed is CU95 which is less than CU120, the proposed exception to IFRS 3 and ASC Topic 805 described in paragraph 31 would apply. Therefore, the amount of recognized goodwill would be the excess of:

(i) **the total consideration transferred, CU305; over**

(ii) **the net of the acquisition date amounts of identifiable assets acquired and of identifiable liabilities assumed, (350-120)= CU230.**

(iii) **Goodwill is (305-230) = CU75.**

(iv) **If the two calculations of goodwill presented above respectively under (f) and (e) are compared, a difference arises: (75-50) =CU25. This equals the difference between the fair value of the insurance liability (CU95) and its measurement under the proposed insurance contracts model.**

(g) **Conclusions**: the example above shows that, if the proposed exception to IFRS 3 and ASC Topic 805 were applied, the difference between the measurement of the insurance liabilities determined under the proposed approach for insurance contracts (CU120) and their fair value (CU95), that is (120-95)=CU25, results in a corresponding increase in the total goodwill recognised in the business combination.

Under a composite margin approach

34. The fact pattern presented above is unchanged as well as the calculation under (e). Instead if a composite margin approach were applied, the calculation determined under (f) above would then become:

(i) **the total consideration transferred, CU305 (did not change); over**

(ii) **the net of the acquisition date amounts of identifiable assets acquired and of identifiable liabilities assumed, (350-100)= CU250.**

(iii) **Goodwill is (305-250) = CU55.**

Therefore, the difference in the goodwill recognised is now: (55-50)=CU5, which is exactly the amount of the difference between the measurement of the liability under the proposed insurance measurement (CU100) and its fair value (CU95).

Staff comments and recommendation

35. Staff conclude that an approach that uses the acquisition date fair value of the insurance liabilities assumed as the calibration point for the residual and composite margin would be consistent with the proposed measurement for insurance contracts. This approach would provide a practical proxy for the measurement under the proposed insurance contracts model (a current measure plus an allocation of a residual or composite margin).

36. However, one question for this approach relates to any negative amounts that occur when the fair value of the liabilities assumed is lower than the current measurement component of the building block approach. Staff conclude that any such negative difference is the result of a *measurement discontinuity* merely arising from two conceptually different measurement approaches (namely fair value under IFRS 3 and the building block model for insurance contracts). Because IFRS 3 and Topic ASC 805 provide some exceptions to the fair value measurement approach in similar situations of measurement asymmetries (eg accounting for assets and liabilities arising from employee benefits), staff believe that in this case an exception should be provided that means that the negative difference is not recognised as an immediate loss but is instead recognised, in effect, as an implicit component of goodwill.

37. Based on the considerations developed above, staff recommend that for contracts acquired in a business combination, the insurer should compare the expected present value of the cash flows [plus the risk adjustment, in the model that uses such an adjustment] with the fair value of those contracts and:

    (a) if the fair value of the contracts exceeds the expected present value of the cash flows [plus the risk adjustment, in the model that uses such an adjustment], the insurer should treat the difference as the [residual margin] [composite margin] at that date;

    (b) if the expected present value of the cash flows [plus the risk adjustment, in the model that uses such an adjustment] exceeds the fair value of the contracts assumed, the insurer should initially measure the contracts assumed at the expected present value of the cash flows [plus the risk adjustment, in the model that uses such an adjustment], rather than their fair value. This exception from the general requirement in IFRS 3 *Business Combinations* and ASC Topic 805 *Business Combinations* would increase the initial carrying amount of goodwill recognized in the business combination.

> **Question for the boards**
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> Do the boards agree with the staff's recommendations in paragraph 37?