IASB Meeting Agenda reference **10A**

Staff Paper Date **June, 2009**

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Project **Insurance contracts**

Topic **Measurement approach for Insurance contracts**

Purpose of this paper

1. In July, staff intends to ask the boards for decisions on the measurement approach for insurance contracts. In preparation for that session, this paper analyses the list of candidate measurement approaches; in particular:

   (a) a current fulfilment value that includes a margin for the cost of bearing risk and a residual margin;

   (b) a measurement approach based on the measurement approach being developed in the project to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (the updated IAS 37 model).

2. As a result of that analysis, this paper proposes some changes to the list of candidate measurement approaches for insurance contracts.

Summary of staff recommendations

3. This paper argues that:

   (a) a measurement approach based on the updated IAS 37 model should be added to the list of candidates, and

   (b) as a result, a current fulfilment value that includes a margin for the cost of bearing risk and a residual margin is no longer needed in the list of candidates.

4. The rest of this paper is divided into the following sections:

   (a) background (paragraphs 7-8)

   (b) What do we know about the model so far? (paragraphs 9-13)

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

(c) What further questions should be answered? (paragraphs 14-16)

(d) The updated IAS 37 model (paragraphs 15-22)

(e) A fulfilment candidate with a margin for the cost of bearing risk (paragraphs 23-28)

(f) The discounted cash flow (DCF) remeasurement model (paragraphs 29-30)

5. Agenda paper 10C is for the IASB Board only and recommends that the IASB should remove the current exit price approach from the list of candidates. (The FASB has already rejected this approach).

6. Agenda paper 10D includes all the approaches considered in this meeting (including those we recommend for removal).

Background

7. Considering the input from comment letters to the discussion paper *Preliminary Views on Insurance Contracts* (DP), the Insurance Working Group and previous board meetings, staff developed a list of measurement candidates for insurance contracts. At the start of this meeting, the candidates being considered by the boards are:

(a) A current fulfilment value that includes a margin for the cost of bearing risk and a residual margin (previously called candidate 3)

(b) A current fulfilment value that includes a composite margin (previously called candidate 4)

(c) A unearned premium approach for the pre-claims period of short-duration contracts (previously called candidate 5) [we will not discuss this approach any further in this paper].

8. In addition, the IASB is considering a current exit price approach as a candidate [the FASB decided in its February 26, 2009 meeting not to explore this candidate].

What do we know about the model so far?

9. The IASB has decided tentatively that the measurement for an insurance liability will use the following three building blocks:

   (a) A current estimate of the expected (ie probability weighted) present value of future cash flows

   (b) Time value of money

   (c) An explicit margin

10. The FASB has decided tentatively to include (a) a current estimate of the expected (ie probability weighted) present value of future cash flows, but has yet to discuss whether the measurement includes (b) time value of money and (c) an explicit margin.

11. Looking at the tentative decisions so far, we also know that:

    (a) the measurement approach should consider all available information.

    (b) at least no net day one gains are recognised [the IASB decided tentatively to limit revenue at inception to incremental acquisition costs; the FASB tentatively decided that the insurer should not recognise any day one revenue].

12. The Insurance Contracts project is developing a measurement approach for contracts with customers (ie policyholders). However, the tentative decisions of the boards so far mean that it, conceptually, cannot be the allocated transaction price approach discussed in the DP on revenue [although we want to consider this candidate for the pre-claims period of short-duration contract]. But it also seems unlikely that the selected approach will be based on current exit price (ie fair value), particularly from FASB's point of view.

13. This means that the insurance project is pursuing a measurement approach that is certainly not an allocated transaction price, probably not fair value, but most likely a current value approach somewhere in between fair value and an allocated transaction price approach.

What further questions should be answered?

14. Some important questions that we so far have been unable to answer conclusively are:

    (a) What cash flows should be included? Direct cost or something more than just the direct costs? Should entity-specific cash flows be excluded?

    (b) Should the margin, particularly the risk margin, represent cost or compensation (ie profit)?

    (c) Should the overall margin be split into two or more components and should some or all of those components be updated each reporting period?

    (d) Should residual parts of the margins react to some or all changes in estimates – in other words, what is the role of the customer consideration for subsequent measurement?

    (e) How should revenue be recognised? And in the income statement, how should revenue be distinguished from changes in circumstances?

15. When we have an answer to those questions (and perhaps some other questions), we basically will know what the measurement model will look like – almost all of the features would have been defined. Over the past meetings, it appeared to the staff that these questions were difficult to answer.

16. We do not intend to answer the questions mentioned in paragraph 14 in this meeting. As mentioned before, this paper focuses on an analysis of the candidates in preparation for a decision-making session in July.

The updated IAS 37 model

17. As a result of the IASB's tentative decisions in its IAS 37 project in April 2009, staff sees the updated IAS 37 model as a possible precedent for insurance contracts. [Agenda paper 10B gives a more detailed discussion on how the updated IAS 37 model could be applied to insurance contracts.] We emphasise that the aim is not to account for insurance contracts under IAS 37, but to use the updated IAS 37 model as a basis for developing the measurement approach for insurance contracts.

18. The objective of the updated IAS 37 model is to measure the amount an entity would rationally pay at the end of the reporting period to be relieved of the

present obligation. This objective is not intended to measure the amount a third party would demand for taking over the liability. Rather, a transfer would be measured from the perspective of the insurer that currently holds the liability.

19. Some may argue that this objective is as hypothetical as a current exit price. However, the draft measurement requirements of the updated IAS 37 model explain that, in the absence of a transfer market for the obligation, the entity can estimate the amount it would rationally pay to be relieved of the obligation by looking at the burden to the entity of fulfilling the obligation over time with the counterparty.

20. Based on the IASB’s tentative decisions in April, staff concludes that:

    (a) an insurance measurement based on the IAS 37 model ticks all the boxes mentioned in paragraphs 9-11.

    (b) although some of the features are similar to those of the other candidates, particularly the fulfilment candidates, it uses an objective that is not covered by any of the approaches currently in the list

    (c) the measurement objective gives a clear principle for what cash flows and margins should be included. It asks the insurer to consider which cash flows and margins affect the amount that it would rationally pay to be relieved of the obligation.

    (d) if a model is used for one type of uncertain liabilities (liabilities accounted for under IAS 37), one would expect it to be considered for another set of uncertain liabilities (insurance contracts).

21. Based on these considerations, staff concludes that the updated IAS 37 model should be added to the list of candidates for insurance contracts.

22. The updated IAS 37 model does not explicitly deal with revenue-generating contracts with customers. Because insurance contracts are such contracts, we may have to consider some issues not addressed in the current draft of the updated IAS 37 model. One of those issues is how to eliminate day one differences; one obvious way would be to include the day one differences in a residual margin like the one considered in one of the fulfilment candidates. We will discuss this in more detail at a future meeting.

Question for the boards

Do you agree with including a measurement approach based on the updated IAS 37 model (modified to exclude day one gains) in the list of candidates for insurance contracts?

A fulfilment candidate including a margin for the cost of bearing risk

23. Staff tentatively defined current fulfilment value as the expected present value of the cost of fulfilling the obligation to the policyholder over time. Staff has so far not found a way to refine or enhance this definition.

24. Current fulfilment value is built around fulfilment cost. Based on the discussions on fulfilment value so far:

    (a) a fulfilment candidate ticks all the boxes mentioned in paragraphs 9-11.

    (b) fulfilment cost provides a basis for filling in some of the features of a measurement attribute but not all. As a result, a fulfilment notion offers some flexibility in defining it and different people may use different approaches in applying it.

25. One of the fulfilment candidates (formerly described as candidate 3) includes a separate risk margin for the cost of bearing risk. Some of those who prefer this approach believe the insurance liability should include a risk margin that reflects only the **cost** of bearing risk, but should not include any further **compensation** (ie profit) that the insurer requires. However, the margin that reflects the cost of bearing risk is, on average, expected to turn into a profit in the income statement. Therefore staff was unable to identify a clear difference between the cost of bearing risk and the compensation for bearing risk and sees the cost of bearing risk as a form of compensation for bearing risk Furthermore, staff has been unsuccessful in defining a risk margin that represents cost (expense) as defined in the IASB's Framework or the FASB Statement of Concepts. If one wants a current fulfilment value with a separate risk margin, perhaps the only solution is to prescribe that approach in a way that includes:

    (a) the expected cash outflows from fulfilling the obligation,

    (b) a risk margin of some form that on subsequent release is expected turn into a profit in the income statement,

(c) another margin component that flows from calibrating to the premium at inception [IASB: premium less incremental acquisition costs].

26. This could be done, but some may conclude that the result is an assembly of prescribed computations, not a representation of an attribute of the liability.

27. In the previous section, staff argued to add the updated IAS 37 model to the list of candidates. If the boards accept that recommendation, staff believes we should remove from the list of candidates the current fulfilment value that includes a separate risk margin for the cost of bearing risk (former candidate 3). That candidate is in our view so similar in many respects to the candidate based on the updated IAS 37 model, that it is not worth pursuing both of these candidates.

28. The other fulfilment value included in the list of candidates uses a composite margin (former candidate 4). The composite margin is a single margin that does not regard a split between a risk margin and other components of the margin as reliable or useful. Staff believes that this particular feature makes it worthwhile to retain this version of the fulfilment approach in the list of candidates.

Question for the boards
Do you agree with the staff recommendation not to include in the list of candidates a current fulfilment value that includes a margin for the cost of bearing risk and a residual margin (former candidate 3)?

The DCF remeasurement model

29. In their project on Financial Instruments, the boards have discussed whether to pursue a remeasurement method based on discounted cash flows (DCF remeasurement method). The DCF remeasurement model estimates a value that reflects the cash flows in an instrument that an entity would realise through the collection or payment of the cash flows with the counterparty of the instrument.

30. The objective of the DCF remeasurement method shares a lot of similarities with the objective of a fulfilment value. At this stage, we therefore do not believe it would be useful to develop a separate measurement approach based on the DCF remeasurement method. We will analyse this candidate further anyway if the boards decide to adopt this model in their Financial Instruments project.

Question for the boards
Do you need more information on the candidates? Have you identified any other candidates the boards should consider?