



Contact(s)	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	The updated IAS 37 model as a candidate for insurance contracts

Purpose of this paper

1. This paper analyses how the measurement approach being developed in the project to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (the updated IAS 37 model) could be applied to insurance contracts. This analysis supports staff's discussion on the list of candidate measurement approaches in agenda paper 10A.
2. This paper does not discuss all the details of the updated IAS 37 model.
3. The rest of this paper is divided into the following sections:
 - (a) Background (paragraphs 4-6)
 - (b) IAS 37 as a precedent for insurance contracts (paragraphs 7-10)
 - (c) Does it make sense to use the IAS 37 model? (paragraphs 11-14)
 - (d) Applying the updated IAS 37 model to an insurance measurement (paragraphs 15-27)

Background

4. One possibility staff has been analysing (and still is analysing) is to develop the list of candidates by using measurement approaches in other existing and future standards. One of those candidates is the updated IAS 37 model.
5. In practice, a measurement under the updated IAS 37 model would be estimated by using building blocks similar to those discussed in the discussion paper

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.

Preliminary Views on Insurance Contracts (DP), although perhaps not identical in all respects. However, up to April, it was not clear where the updated IAS 37 model would end up. The IASB still had to conclude on the updated IAS 37 model, including the role of margins. For that reason, staff did not include it in the list of candidates.

6. However, staff believes that the discussion on the IAS 37 project in April 2009 may have changed that situation. [For a summary of the tentative decisions made by the IASB on the IAS 37 project, we refer to the appendix to this paper].

IAS 37 as a precedent for Insurance

7. The IASB has previously decided tentatively that liabilities within the scope of the Liabilities project (the project to amend IAS 37) should be measured at the amount the entity would rationally pay at the end of the reporting period to be relieved of the present obligation, ie to settle it or to transfer it to a third party. In April 2009, the IASB discussed how an entity could estimate this amount using expected cash flow techniques, specifically for an obligation that is fulfilled by undertaking a service.
8. Obligations from contracts with customers generally are not in the scope of IAS 37 (except for contracts that have become onerous). Insurance contracts are contracts with customers. Therefore, some may argue that the updated IAS 37 model is not a relevant precedent for insurance contracts.
9. However, staff identified the following reasons why the updated IAS 37 model can be considered as a precedent for insurance contracts:
 - (a) The IASB developed the updated IAS 37 model for liabilities that generate uncertain cash flows. Insurance contracts also generate such liabilities.
 - (b) Warranty obligations are currently within the scope of the existing IAS 37 (although warranties will be brought in the scope of the future revenue recognition standard). Warranties are identical to insurance contracts; technically, warranties even meet the definition of an insurance contract.

- (c) The updated IAS 37 model can be applied to both pre-claims stand ready obligation and a claims obligation, so one single model can deal with both pre-claims and claims obligations¹.
10. The aim of considering the updated IAS 37 model is not to account for insurance contracts under IAS 37, but to consider whether to use that model as a basis for developing the measurement approach for insurance contracts. But the fact that insurance contracts are contracts with customers could result in adding some requirements on top of the updated IAS 37 model, for example modifying it to exclude day one gains. We come back to this in paragraphs 26-27.

Does it make sense to use the IAS 37 model?

11. Does it make sense to measure insurance contracts at an amount based on the amount the entity would rationally pay on the reporting date to be relieved of the present obligation? What usually happens in practice for insurance contracts:
- (a) There is no active secondary market for insurance contracts. Transfer of the obligation at the reporting date to another insurer is therefore uncommon. So is settlement with the counterparty at the reporting date; for an insurance contract, such a transaction is often known as a commutation. However, commutations are rare. They often arise because the insurer or policyholder is in distress.
 - (b) Therefore, an insurer generally fulfils the obligation with the policyholder over time. In that process, insurance companies sometimes outsource some of the activities that are necessary to fulfil the obligations to the policyholder.
12. The DP looked at a possible transfer to a market participant, ie what would a market participant require for taking over the obligation. The fact that insurers generally do not transfer their liabilities was the main reason why respondents generally objected to the DP model; it would require insurers to consider estimates of a hypothetical market participant. Respondents generally preferred a model that considers the insurer fulfilling the obligation with the policyholder over time.

¹ The pre-claims period refers to the coverage period when the insurer is standing ready to meet valid claims. The claims period is the period when the insured events have occurred but the ultimate payment is still uncertain.

13. The objective in IAS 37 is to measure the amount that the insurer would rationally pay to be relieved of a liability. Some may argue that this objective would be as hypothetical as the measurement objective in DP; in many cases there will not be an active market for insurance contracts. However, in the absence of an active market, the updated IAS 37 model clarifies that the insurer can estimate that amount by looking at the burden to the insurer of having to fulfil the obligation over time.
14. In some, perhaps even many, cases liabilities measured under IAS 37 will be estimated by looking at the burden of fulfilling the obligation because there is no efficient market to transfer the obligation or no external party to outsource the service obligations to. If we use this estimation model for liabilities within the scope of IAS 37, we see no reason not to consider the same model for insurance contracts.

Applying the updated IAS 37 model to an insurance measurement

15. The measurement of an insurance liability can be analysed by using the following three building blocks²:
 - (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.
16. In its April 2009 meeting, the staff on the IAS 37 project presented a paper that discussed measurement guidance for the revised IAS 37 (April 2009, agenda paper 8A and appendix to agenda paper 8A). Looking at both the measurement requirements described in those papers and the tentative decisions the IASB made in April 2009 (see appendix to this paper), we conclude that the updated IAS 37 model can be analysed in a way that matches the building blocks mentioned in paragraph 15.

² The IASB decided tentatively in its February 2009 meeting to use those building blocks in a measurement for insurance contracts. The FASB also decided tentatively to include (a), but has yet to discuss whether the measurement includes (b) and (c).

17. We now look at how the measurement requirements for the updated IAS 37 model could be applied to insurance contracts, focusing on some of the important questions on cash flows and margins that came up during earlier discussions on insurance. However, we cannot fill in all the details now and probably have to discuss some issues in more detail at a later stage.

What cash flows should be included?

18. The objective is to measure the amount that an entity would rationally pay to be relieved of the obligation. This approach does not exclude cash flows that are specific to the insurer; the entity would consider those cash flows in determining what it would rationally pay to be relieved of the obligation. This is consistent with the fact that, in estimating that amount, the insurer would typically look at the burden of fulfilling the obligation itself.
19. In estimating what it would rationally pay to be relieved of the obligation, an insurer arguably would consider both direct costs and indirect costs associated with fulfilling that obligation.

Should a separate risk margin be included?

20. The proposed IAS 37 measurement guidance requires a risk adjustment if, and to the extent that, possible variations in the amount or timing of the future cash flows affect the amount that the entity would rationally pay to be relieved of the present obligation.
21. Variability of the cash flows is a significant inherent characteristic of an insurance contract. Fundamental to insurance is taking on risks from other parties and managing those risks. If the insurer considers risk when it takes on an obligation, it seems natural to presume that an insurer also considers risk in the amount that it would rationally pay to be relieved of an obligation.
22. Consider two insurance liabilities that generate cash flows with the same expected present values but differ in risk. In that case, the insurer would rationally pay a higher amount to be relieved of the riskier liability. We therefore conclude that applying the updated IAS 37 model to insurance liabilities would result in including a risk adjustment.

23. The risk margin would reflect the amount the insurer would be willing to pay to be relieved from bearing risk³. The risk margin flows from the measurement objective. Therefore, the risk margin should be updated each reporting period and is part of the insurance liability.

Should a separate margin for services be included?

24. In estimating the amount to be relieved of the obligation, the insurer would not only consider (the service of) bearing risk. The insurer would also include a margin (ie profit) it demands for services other than bearing risk (if any). That margin may not be material in all cases.
25. In some cases the insurer provides services as part of an insurance contract that could also be provided on a stand-alone basis, eg. fund management services or car repairs. An insurer would generally not commit to provide those services without compensation; in some cases that compensation is explicitly charged to the policyholder. Under the updated IAS 37 model, the measurement of the insurer's liability would include the profit a contractor would require for undertaking a service. If there is no efficient market for such services, the measurement would include the profit the insurer would itself require for providing such services⁴.

Day one differences

26. In February 2009, the boards decided tentatively that an insurer should not recognise revenue or gains at the inception of an insurance contract. [The IASB, but not the FASB, would require an insurer to recognise at inception that part of the revenue that provides recovery of the incremental acquisition costs incurred.]

³ In principle, an adjustment for risk could also be made by adjusting estimates of cash flows, adjusting the probabilities or adjusting the rate used to discount the expected cash flows to their present values. We view all of these approaches as different ways of developing a risk margin, not as something different from a risk margin.

⁴ Because a margin for other services reflects the profit on other services, the expenses related to those services would be included in the cash flow building block.

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27. Therefore, if the initial measurement of the insurance liability using the updated IAS 37 model is less than the premium⁵ received at that date, the insurer would include that difference in the initial measurement of the liability. For convenience, as in previous papers, we refer to this explicit adjustment as the residual margin. The residual margin could not be negative.

⁵ For the FASB, the comparison is with the premium. For the IASB, the comparison is with the premium excluding the part of the premium needed for recovery of the incremental acquisition costs.

Appendix - Tentative decisions on IASB's project to amend IAS 37

1. The IASB decided tentatively that liabilities within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* should be measured at the amount the entity would rationally pay at the end of the reporting period to be relieved of the present obligation, ie to settle it or to transfer it to a third party.
2. In the absence of an efficient market for the obligation, the amount the entity would rationally pay to be relieved of the obligation can be estimated by the burden to the entity of fulfilling the obligation.
3. If the entity has to undertake a service to fulfil the obligation, the relevant cash flows are the amounts that the entity would rationally pay a contractor to undertake the service on its behalf. They are the amounts the entity would pay when the time comes to fulfil the obligation, ie not what it would 'prepay' at the reporting date.
4. The IASB decided tentatively that, in the absence of an efficient market for those services, the entity could estimate the amount it would rationally pay a contractor by estimating the amount it would itself charge another party to carry out the service. The latter amount would include the entity's estimates of the costs it expects to incur in fulfilling the obligation and the compensation it requires for providing the service inherent in the obligation.
5. A risk adjustment is required if, and to the extent that, possible variations in the amount or timing of the future cash flows affect the amount that the entity would rationally pay to be relieved of the present obligation.