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Project **Insurance contracts**

Topic **Measurement approach**

Purpose of this paper

1. The Board is currently considering two measurement approaches (both modified to exclude day one profits):

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

   (b) a current fulfilment value that includes a composite margin.

2. This paper asks the Board to select one of these two approaches.

3. The current project plan aims at issuing an exposure draft in December 2009. It is therefore critical that the Board decides on the measurement approach during the September meeting.

Summary of staff recommendations

4. This paper recommends that the Board select the approach described in paragraph 1(a) (the updated IAS 37 model (modified to exclude day one gains) as the measurement approach for insurance contracts).

5. The FASB has tentatively selected the approach described in paragraph 1(b) (current fulfilment value that includes a composite margin). The staff believe that the FASB is unlikely to change that decision in the short term. Selecting the IAS 37 measure means that the Board's tentative decision on the measurement approach would differ from FASB's tentative decision. If this difference in

views is not resolved before we publish an exposure draft, the exposure draft should ask constituents for input on the two different approaches, presumably also reiterating that the boards' objective would still be ultimately to have a converged approach.

Structure of the paper

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

   (a) Background (paragraphs 8-10)

   (b) Board discussions on the IAS 37 project (paragraphs 11-12)

   (c) The similarities between the candidates (paragraphs 13-20)

   (d) The differences between the candidates (paragraphs 21-29)

   (e) Selecting one of the candidates (paragraphs 30-34)

   (f) Deposit floor (paragraphs 35-37)

7. It is beyond the purpose of this paper to discuss:

   (a) detailed measurement guidance, such as estimating the expected cash flows and discount rates;

   (b) non-performance risk. A discussion of this issue now would be premature given the IASB's discussion paper *Credit Risk in Liability Measurement*¸ on which comments were due on 1 September.

Background

8. On 21 July, 2009, the FASB tentatively selected a current fulfilment approach with a composite margin as the measurement approach for insurance contracts. The FASB reconfirmed this decision at the July 23 joint meeting.

9. In its July meeting, the Board (the IASB) did not reach a clear consensus on what the objective for the measurement approach should be. The current list of candidates considered by the Board includes two candidates: a current fulfilment value with a composite margin and the updated IAS 37 model.

10. One of the reasons the Board has not concluded on the measurement approach for insurance is that it has not yet finalised the IAS 37 model on which the insurance requirements might be based.

Board discussions on the IAS 37 project

11. In the June[1] and July[2] papers, we explained how the proposals in the IAS 37 project could be applied in a measurement model for insurance. Based on the Board's discussions in the IAS 37 project so far, we know that applying that model to an insurance contract means:

    (a) an insurer should measure an insurance liability at the amount it would rationally pay at the end of the reporting period to be relieved of the present obligation.

    (b) an active transfer market for insurance contracts is usually absent; in most cases the liability would be measured at the value of not having to fulfil the obligation.

    (c) in determining the value of not having to fulfil the obligation an insurer should use a expected present value estimation technique (building block approach) that would take into account:

        (i) the value to the insurer of avoiding the future outflows expected to be required to fulfil the obligation;

        (ii) the value to the insurer of avoiding the risk in amount or timing of the outflows; and

        (iii) the time value of money

12. In September 2009, the IAS 37 staff will continue its discussion with the Board on guidance for estimating future cash flows for those obligations that the entity fulfils by undertaking a service for (rather than paying cash to) the counterparty ('service obligations').

The similarities between the candidates

13. In the paper for the July Board meeting, we described the similarities between the two candidates. In this section, we update the similarities for the latest staff recommendations in the IAS 37 project. We also consider Board members' comments made during the July meeting.

    (a) The measurement perspective (paragraph 14)

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[1] June 2009, Agenda Paper 10A
[2] July 2009, Agenda Paper 11A

(b) The building block overlay (paragraphs 15-16)

(c) Financial market variables (paragraph 17)

(d) Day one gains (paragraphs 18-20)

The measurement perspective

14. Both the updated IAS 37 model and the current fulfilment value measure the insurance liability from the perspective of the insurer, not from the perspective of other market participants. Consequently, both models measure cash flows from the perspective of the insurer and therefore do not exclude cash flows specific to the insurer.

The building block overlay

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

    (a) current estimates of (expected, ie probability-weighted) future cash flows;

    (b) time value of money;

    (c) an explicit margin.

16. Because there typically is no active transfer market for insurance contracts, both candidates generally use this building block overlay for measuring the liability.

Financial market variables

17. The measurement approach should consider all available information. In this context, the Board specified that the measurement should use estimates of financial market variables that are as consistent as possible with observable market prices. As a result, we do not expect a difference between the two candidates in relation to financial market variables like interest rates or equity prices.

Day one gains

18. The Board has decided tentatively that an insurance measurement should not lead to the recognition of positive day one differences in profit or loss (ie day one gains) and limit revenue at inception to incremental acquisition costs.

19. Considering that insurance contracts are with customers (policyholders), both candidates are going to be hybrid approaches of:

(a) a current measure, either the updated IAS 37 model or current fulfilment value; and

(b) an allocation model for the day one difference, ie the residual margin (in the IAS 37 approach) or composite margin (in the fulfilment approach).

20. The current measure (paragraph 19(a)) determines what elements should be part of a measurement of the liability at all times, even if a contract is onerous. The allocated part (paragraph 19(b)) includes in the liability the day one difference that would have been recognised in profit or loss at inception if the Board had decided to recognise day one gains.

The differences between the candidates

21. The July paper on measurement candidates also described the differences between the two candidates. In this section, we update these differences for the latest staff recommendations in the IAS 37 project.

(a) Precedents from existing standards and other projects (paragraphs 22-23)

(b) The measurement objective (paragraphs 24-25)

(c) Service activities (paragraphs 26-27)

(d) Risk margins (paragraphs 28-29)

Precedents from existing standards and other projects

22. The updated IAS 37 model finds its precedent in the Board's project to amend IAS 37. In that context it is quite natural for the Board to consider, and perhaps select, a measurement for insurance contracts that will be used for other types of uncertain liabilities.

23. Current fulfilment value has been developed within the insurance project as a candidate. It does not have a precedent in other existing standards or projects. Nevertheless, the staff see no obstacle within the Board's *Framework* that would preclude the use of this objective.

The measurement objective

24. The measurement objective of the IAS 37 project builds on the amount an insurer would rationally pay to be relieved of an obligation. Although this

objective acknowledges that insurers typically fulfil their insurance liabilities, it also specifically takes into account cases where there is objective evidence of a transfer or settlement amount.

25. The objective of current fulfilment value is to measure the expected present value of the cost of fulfilling the obligation to the policyholder over time. Many respondents to the Discussion Paper *Preliminary Views on Insurance Contracts* preferred this objective, rather than a current exit price objective, because they view a fulfilment objective as more consistent with how insurers typically conduct their business.

Service activities

26. In its IAS 37 project, the Board decided tentatively that the measurement includes estimates of cash flows for service activities based on what a subcontractor would charge to undertake the services. 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 includes the profit an entity would require for those services (a service margin).

27. As mentioned earlier, the IAS 37 team intends to elaborate on this requirement in the September meeting. The outcome of that debate could result in a difference between the updated IAS 37 model and a current fulfilment value. Current fulfilment value as included in the list of candidates does not require cash flows for service activities based on what a subcontractor would charge to undertake the services. Accordingly, a current fulfilment value does not include a service margin. Thus, the service margin is an implicit component of the composite margin used in that approach.

Risk margin

28. The IAS 37 measurement objective provides a basis for a risk margin. The risk margin includes the value to the entity of avoiding the risk in amount or timing of the outflows. It reflects the fact that an insurer would rationally pay different amounts to be relieved of two liabilities that differ in riskiness but are otherwise the same.

29. Current fulfilment value as included in the list of candidates does not include a separate risk margin. Thus, the risk margin is an implicit component of the composite margin used in that approach.

Selecting one of the candidates

30. In many respects, the two candidates considered in this paper are similar. In paragraphs 22-29 we analysed the differences between them. We now summarise arguments for each of the two candidates.

31. Arguments presented by those who favour the updated IAS 37 model are:

    (a) It builds on a precedent from another project that also deals with uncertain liabilities, namely IAS 37. This enhances consistency across IFRSs and reduces the need for industry-specific guidance.

    (b) The updated IAS 37 looks at what the insurer would rationally pay to be relieved of the obligation. Arguably, this measurement objective therefore could need less additional guidance for resolving existing and emerging issues than a current fulfilment value for some features (for example for determining which costs would be included in the measurement).

    (c) The updated IAS 37 model provides a basis for risk (and possibly service) margins; they flow from the objective.

32. Arguments presented by those who favour current fulfilment value are:

    (a) The candidate based on current fulfilment value does not include risk and service margins that are separately identified and updated. Such margins add unnecessary complexity and often can only be determined subjectively. Furthermore, the onerous test in the boards' proposed model for revenue recognition would not include a margin if the contract becomes onerous. Because a current fulfilment value does not include an updated risk and service margin, it would also be more consistent with the boards' proposed revenue recognition model.

    (b) The updated IAS 37 model is bound to the measurement guidance developed in the IASB's IAS 37 project (presuming that one wants to stay as consistent as possible). In contrast, a current fulfilment value allows the Board to tailor the measurement approach to reflect the specific characteristics of insurance contracts.

    (c) A current fulfilment value is as close as possible to how insurers typically conduct their business and does not require estimates of

unobservable market inputs. Some of the guidance on the updated IAS 37 model, for example the guidance around subcontractors' cash flows, may require such estimates (subject to the Board's discussion of this issue in September).

33. Considering the arguments in paragraphs 31 and 32, the staff recommend that the Board select the updated IAS 37 model (modified to exclude day one gains) as the measurement approach for insurance contracts, particularly for consistency with the measurement of liabilities within the scope of IAS 37. Provided that the Board concludes on the measurement approach in its IAS 37 project, staff have not identified any reasons why the Board should adopt a different measurement approach for insurance contracts.

Question for the Board
Do you agree with staff recommendation in paragraph 33 to select the updated IAS 37 model (modified to exclude day one gains) as the measurement approach for insurance contracts?

34. FASB has tentatively selected a current fulfilment value with a composite margin. The staff believe that the FASB is unlikely to change that decision in the short term. Selecting the IAS 37 measure means that the Board's tentative decision on the measurement approach would differ from FASB. If this difference in views is not resolved before we publish an exposure draft, the exposure draft should ask constituents for input on the two different approaches, presumably also reiterating that the boards' objective would still be ultimately to have a converged approach.

Deposit floor

35. At the July meeting, some Board members noted that, for both candidates, it was not clear whether the measurement would include a deposit floor (ie an insurance liability with a demand feature would not be less than the amount payable on demand).

36. Staff believe that whether the deposit floor is part of the measurement does not flow from each candidate's objective directly:

(a) The amount an insurer would rationally pay to be relieved of the obligation would not necessarily be bound to the amount payable on demand.

(b) The future costs the insurer expects to incur in fulfilling the liability would not necessarily reflect the amount payable on demand.

37. The deposit floor arguably is not a distinguishing feature of the candidates and therefore should in our view not be a relevant factor in choosing between the two candidates at this stage.