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Project **Insurance Contracts**

Topic **Measurement objective**

Purpose

1. At their October joint meeting, the boards discussed the similarities and differences between their preliminary decisions on a measurement approach. At a high-level, the boards agreed with a three building block approach. The Boards asked the staff to analyse the potential remaining differences between the boards' views on the measurement model. In addition, the boards asked the staff to draft a measurement objective that included both boards' views and tentative decisions made to date on measurement.

2. This paper provides a brief overview of the building block approach and seeks a tentative decision (in the case of the IASB a reaffirmation of a tentative decision) about these building blocks. In addition, this paper discusses whether an entity should recognize a negative day-one difference in profit or loss. This paper also provides a draft of a measurement objective for insurance contracts with an analysis of the language (and intent of the language) used in that objective.

3. This paper discusses a measurement objective for insurance contracts, which includes splitting the "third" building block (explicit margin) into two components: a risk adjustment and a residual margin. We emphasise that the discussion about measurement in this paper is inherently linked to the discussion about margins in Agenda Paper 7B (FASB Memorandum 32B), which discusses

the basis for a risk adjustment in the context of the measurement objective. Accordingly, these papers must be read concurrently.

4. This paper does not address the following issues, which will be considered separately:

   (a) Embedded derivatives. This topic is discussed in Agenda Paper 7C (FASB Memorandum 32C).

   (b) Presentation of the statement of financial position and the performance (income) statement. Presentation of the income statement is discussed further in Agenda Paper 7E (FASB Memorandum 32E). Presentation of the insurance liability in the statement of financial position, including whether items should be presented gross or net, will be discussed at a future meeting.

   (c) Unearned premium approach. The topic about whether the unearned premium approach provides an approximation of the insurance liability will be discussed at a future meeting.

Summary of the staff's recommendation

5. The staff recommends that a building block approach be used to measure an insurance contract. That approach consists of expected probability-weighted cash flows, incorporating the time value of money, and an explicit margin that is split into (a) a risk adjustment and (b) a residual margin.

6. The staff also recommends that an entity should recognize a day-one loss in profit or loss.

Structure of the paper

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

   (a) Building block approach (paragraphs 8 through 21)

   (b) Advantages of the proposed measurements (paragraph 22 through 25)

   (c) Measurement objective (paragraphs 26 through 32)

Analysis

Building block approach

8. Throughout the insurance contracts project, the boards have discussed the building block approach. This approach acts as a guideline for (a) identifying the significant components of any current measurement and (b) providing a framework for discussing a measurement objective. Admittedly, a building block approach to measurement does not dictate the ultimate measurement (an objective provides that information) but provides a starting point for that discussion.

9. For measuring insurance contracts, the staff has presented in previous papers a building block approach based on three components. Those three components can be described as follows:

   (a) Current estimates of expected (that is, probability-weighted) future cash flows

   (b) Reflect the time value of money

   (c) Include an explicit margin

10. The building blocks are intended to address the measurement of an insurance contract. That is, the building blocks would apply to:

   (a) the future cash inflows (premiums)

   (b) the future cash outflows (claims, benefits, and expenses), and

   (c) the difference between these cash flows (margins).

11. The contract position of an insurance contract therefore consists of i) the future cash inflows and ii) the future cash outflows plus the margin. This contract position could be presented either:

   (a) gross: i) the future cash inflows as an asset and ii) the future cash outflows plus the margin as a liability, or

   (b) net: i) the future cash inflows less ii) the future cash outflows plus the margin, either as a net asset or net liability.

12. We will discuss the gross versus net presentation at a future meeting. [Typically, a net presentation of the contract position results in a liability throughout the life of the contract.]

13. The building blocks are applied in an explicit way rather than treated as implicit parts of an overall measurement. That is to say, each building block is identified separately from the other components.

14. The outcome of an insurance contract can be highly variable because uncertainty is an inherent characteristic of insurance contracts and some of those contracts cover many reporting periods. As a result, the insurance measurement should not only report performance under the contract, but also changes in circumstances.

15. To report changes in circumstances promptly, the measurement should at least update estimates of current cash flows and of the time value of money at the end of each reporting period. [We discuss subsequent treatment of the margin in Agenda Paper 7B (FASB Memorandum 32B)].

16. The measurement considers all available information. Because a market does not exist for insurance contracts, the measurement is based principally on the insurer's inputs and does not require the search for market inputs, except for market variables such as interest rates. For example, the measure requires the use of observable market prices to determine inputs such as interest rates or, when the payouts on an insurance contract are linked to equity prices, those prices.

17. As noted in paragraph 14, the outcome of an insurance contract can be highly variable because of the uncertainty in the timing and amount of the future cash flows. The uncertainty inherent in the future cash flows creates certain challenges with the measurement. Differentiating between similar contract with different potential outcomes is difficult. For example, the probability-weighted average of two contracts may be the same (100). However, the potential range of outcomes for one contract (99 to 101) as compared to the other contract (0 to 200) is not readily apparent in the measurement. Accordingly, the boards have previously had education sessions and discussions about the use of a risk adjustment. The risk adjustment represents an amount for the effects of

uncertainty about the amount and timing of future cash flows. The risk adjustment should be included in the measurement in an explicit way, separate from the unbiased estimate of the future cash flows.

18. Additionally, the boards tentatively decided that no recognition of positive day one differences in profit or loss (day one gains) should occur. Consequently, that te ntative decision results in the insurance liability being calibrated to the premium at inception through the creation of a margin (in instances where the insurance contract is not onerous at inception). The measurement therefore is going to be a hybrid of:

    (a) a current measure (the 'blocks' described in paragraph 9(a) and 9(b) as well as a risk adjustment which is part of the 'block' described in paragraph 9(c)), and

    (b) an allocation model for the residual day one difference (that is, the difference arising from the premium received and the measurement of the insurance liability which consists of the remaining part of the 'block' described in 9(c)).

19. Accordingly, the margin should be split into i) a risk adjustment and ii) a residual margin (as further discussed in agenda paper 7B (FASB Memorandum 32B)). The 'third' building block, the margin, would be split into:

    (a) a risk adjustment for the effects of uncertainty about the amount and timing of future cash flows (a risk adjustment) that would be part of the current measure (paragraph 18(a)), and

    (b) an amount to eliminate any positive day one difference (a residual margin) that would be dealt with by the allocation model (paragraph 18(b)).

Recognition of negative day one differences

20. At a previous meeting, the IASB tentatively decided that, if the initial measurement of an insurance contract results in a day-one loss, the insurer should recognise that day-one loss in profit or loss. The FASB did not make a decision about a day-one loss.

21. A day-one loss arises when a contract is onerous at inception; that is, the insurance liability (obligation) exceeds the premium (consideration). This situation can occur in instances where a product is designed to be a loss leader as part of an entity's broader strategy to increase market share. Both recent discussions in the revenue recognition project (the onerous test) and current accounting for insurance contracts (premium deficiency and liability adequacy tests) support recognizing an expense when the obligation exceeds the consideration.

Advantages of the proposed measurement

22. In the staff's view, a measurement using the building blocks provides several benefits to users of an insurer's financial statements:

(a) Relevant information about the amount, timing, and uncertainty of future cash flows arising from existing insurance contracts. Given the uncertainty associated with insurance liabilities and the long duration of many insurance contracts, such information is particularly important.

(b) A requirement for insurers to make explicit estimates of cash flows and margins, rather than rely solely on the implicit margins that existed at inception. This should result in more useful information for users of an insurer's financial statements.

(c) A consistent approach to changes in estimates. In most existing approaches, a liability adequacy test exists and this implicitly recognises some favourable changes by offsetting them against adverse changes. Thus, these existing approaches recognise favourable changes arbitrarily, depending on whether adverse changes occur at the same time and on the size of implicit margins that existed at inception.

(d) An appropriate and consistent approach that could be applied to all types of insurance (and reinsurance) contracts, that also provides a coherent framework to deal with more complex contracts (such as multi-year, multi-line, or stop loss

contracts) and to resolve emerging issues without resorting to arbitrary new rules and distinctions.

(e) Consistency with other accounting models that require current estimates of future cash flows in measuring liabilities.

(f) No need to separate embedded derivatives because the proposed measurement achieves the main benefits that a fair value measurement achieves.

(g) No need for anti-abuse rules to prevent selective recognition of previously unrecognised economic gains through reinsurance.

(h) Clearer reporting of economic mismatches between insurance liabilities and related assets, and a reduction in accounting mismatches.

(i) For financial market variables, consistency with observable current market prices, to the extent they are available. For those variables, such prices provide a more understandable and credible benchmark for users.

23. Respondents to the discussion paper on insurance contracts rejected current exit value because:

    (a) Current exit value requires the insurer to use market-consistent cash flows, rather than entity-specific cash flows. Many respondents would prefer to use entity-specific cash flows.

    (b) The discussion paper concludes that current exit value reflects the credit characteristics of the liability. Some respondents agreed with this conclusion, while others disagreed. Most respondents, including many of those who agreed with that conclusion, opposed a measurement that reflects the credit characteristics of the liability.

    (c) Some respondents suggested that, although current exit value might often be very close to settlement value in practice, and perhaps even the same amount, current exit value is the wrong objective for items that will not be, and often cannot be, transferred.

Staff Recommendation

24. The staff recommends that a building block approach be used to measure an insurance contract. That approach consists of expected probability-weighted cash flows, incorporating the time value of money, and an explicit margin that is split into a risk adjustment and a residual margin. The staff believes that the use of these building blocks can appropriately reflect the complexities underlying an insurance contract.

25. The staff also recommends that an entity should recognize a negative day-one difference in profit or loss. The staff believes that the recognition of a negative day-one difference is not only consistent with existing practice but is also consistent with current discussions in other relevant projects. Further, the staff believes that the recognition of a negative day-one difference provides useful information to users about management's strategic initiatives and the impact of those initiatives on an entity's profitability.

Question for the boards
Do the boards agree (reaffirm in the case of the IASB) that a building block approach as described in the staff recommendation in paragraph 24 should be used for measuring insurance contracts? Do the boards agree (reaffirm in the case of the IASB) that, if the initial measurement of an insurance contract results in a negative day-one difference, an entity should recognise that difference in profit or loss?

Measurement objective

26. The following is a preliminary drafting of a measurement objective for insurance contracts. The purpose of this draft language is not to agree on the exact wording but rather to help the staff with refining a common objective. The objective (and explanatory language) is as follows:

> **A reporting entity should measure an insurance contract equal to its current estimate of the cost to fulfil the present obligation created by that contract.**
>
> A reporting entity should estimate that cost using present value techniques that consider:
>
> i. the unbiased, probability-weighted average of future cash flows;

ii. the time value of money;

iii. a risk adjustment for the effects of uncertainty about the amount and timing of future cash flows; and

iv. an amount to eliminate any positive day one difference.

The data used in these present value techniques can be distinguished into two types:

i. market variables: variables that can be observed in, or derived directly from, markets (eg prices of publicly traded securities and interest rates)

ii. non-market variables: all other variables (eg the frequency and severity of insurance claims and mortality).

Estimates of market variables should be consistent with the observable market prices at the end of the reporting period. An insurer should not substitute its own estimate for the observed market prices, even if other evidence causes the insurer to believe that those prices are unrepresentative of conditions at the end of the period.

Estimates of non-market variables should reflect all available evidence, both external and internal. External data (eg national mortality statistics) may have more or less weight than internal data (eg internal mortality statistics), depending on the circumstances. For example, a life insurer should not rely solely on national mortality statistics, but should consider all other available internal and external sources of information in developing unbiased estimates of probabilities for mortality scenarios. In developing those probabilities, an insurer should consider all evidence available, giving more weight to evidence that is more persuasive. For instance, internal mortality statistics may be more persuasive than national mortality data if the internal statistics are derived from a large population, the demographic characteristics of the insured population differ significantly from those of the national population and the national statistics are out of date; in that case, an insurer would place more weight on the internal data and less weight on the national statistics. Conversely, if the internal statistics are derived from a small population with characteristics believed to be close to those of the national population, and the national statistics are current, an insurer would place more weight on the national statistics.

Brief analysis of draft language

27. The objective (sentence in bold) conveys key aspects of the measurement approach. These aspects are:

(a) The use of "its" establishes that the measurement is entity-specific and the starting point is based an entity's view of its own estimated cost to fulfil the contract.

(b) "Current estimate of the cost to fulfil" communicates that the estimate of the cost to fulfil is required to be updated each reporting period. That is, an entity should review its estimates at the end of the reporting period and update them if evidence indicates that previous estimates are no longer valid. The notion of remeasurement is part of the first of the three building blocks discussed in the first section of this paper. In addition, the objective is not to measure a past price (cost-based) but rather to provide useful information for existing conditions.

28. The next sentence and related bullet points describe how an entity would achieve the objective. The wording is similar to the building blocks that have been discussed throughout the insurance contracts project. However, some changes were made:

(a) "Current" is not used here because it is part of the objective.

(b) "Unbiased" has been introduced to point out that the future cash flows initially cannot contain a bias that may be double-counted by the inclusion of an adjustment for uncertainty. The adjustment for uncertainty should be included in the measurement separate from the unbiased estimate of the future cash flows.

(c) The "explicit margin" would be split into two separate 'blocks':

(i) an amount for the effects of uncertainty about the amount and timing of future cash flows as part of the measurement objective (a risk adjustment)

(ii) an amount to eliminate any positive day one difference (a residual margin) and release it over time.

Data used in present value techniques

29. The next paragraphs provide details about what data should be used. Two types of data are highlighted: market variables and non-market variables. For variables such as interest rates, equity prices, and embedded derivatives, the use of market data is required. However, this paragraph also means that an entity would not have to look for inputs to a hypothetical market to satisfy the

requirements that exist under a market-participant view (sometimes referred to as a "search and destroy" for finding market data).

30. In prior deliberations, two concerns in particular were raised on the role of market-based guidance, for example guidance around using contractors' prices, for determining inputs to the measurement.

    (a) One view is that the objective is integral to how the measurement approach will be applied in practice. That is, the objective of the measurement approach will dictate future interpretations as practice issues emerge and will be instructive in resolving those issues. Referring to market-based guidance may therefore steer the measurement towards a transfer-based market participant notion and might bring some hypothetical market elements into the measurement.

    (b) Another view is that, because a market does not exist for insurance contracts, the building block approach for insurance contracts is based principally on the insurer's inputs and does not require the search for market inputs (except for market variables such as interest rates). However, the market-based guidance provides discipline around the estimation process.

31. The staff believes that the sequencing of the proposed wording for the measurement objective addresses both views. The perspective of the measurement objective is clearly from the entity's view rather than from a market participant view. However, the measurement should be based on all available information. The clarification about market variables and non-market variables provides a means by which market variables must be included in the measurement when no entity-specific evidence is expected to be more relevant than that market evidence (particularly for financial market variables).

Non-performance risk

32. The proposed measurement model for an insurance contract described in paragraph 26 does not include changes in the insurer's non-performance risk. The staff proposes that the measurement of insurance contracts should not be

updated for changes in the insurer's non-performance risk. Consequently, the staff does not plan to bring this topic to the boards unless the boards determine that an in-depth analysis is needed.

Question for the boards

Do the boards agree that:

A reporting entity should measure an insurance contract equal to its current estimate of the cost to fulfil the present obligation created by that contract.

A reporting entity should estimate that cost using present value techniques that consider:

i. the unbiased, probability-weighted average of future cash flows;

ii. the time value of money;

iii. a risk adjustment for the effects of uncertainty about the amount and timing of future cash flows; and

iv. an amount to eliminate any positive day one differences (residual margin)?

Do the boards want to have a separate discussion about non-performance risk for the proposed measurement for insurance contracts in a follow-up meeting?

Appendix A

A1. The following appendix briefly describes the background on the two measurement approaches previously discussed by the boards. The boards have been discussing these approaches and the related objectives in parallel.

A2. The IASB had tentatively decided that the measurement should be based on the measurement being developed in the project to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, modified to exclude day one gains (the updated IAS 37 approach). See Appendix B for a summary of the proposals. The objective is "to measure the amount that the entity would rationally pay on the reporting date to be relieved of the present obligation." That amount is the lowest of three possible amounts (although in practice the result will usually be the same one of these amounts, namely the value the entity would gain if it did not have to fulfil the obligation). The FASB has tentatively decided that the measurement should be based on current fulfilment value. Unlike the updated IAS 37 approach, current fulfilment value was developed specifically in the context of the insurance project. The objective of current fulfilment value is in the process of being developed and is described as "the expected present value of the cost of fulfilling the obligation to the policyholder over time."

A3. One area that the boards have discussed on several occasions is the use of a market participant view in the measurement.[1] Under the IAS 37 approach, one of the alternatives is to use the amount the entity would have to pay a third party to transfer the obligation to that party. However, active secondary markets currently do not exist for most insurance contracts and an entity generally cannot legally transfer most insurance contracts to a third party without policyholders' or regulators' approval. Consequently, while transfer is one possible determinant of the measurement being developed in the project to amend

[1] The discussion about the use of a market participant view should not be confused with the use of observable market inputs in the proposed measurements. Both boards have tentatively agreed that observable market inputs should be used when available, particularly for financial market variables. The discussion about the use of a market participant view is whether market prices overrule all other forms of evidence and an entity in that process would have to create a hypothetical market when no market exists and/or perform a "search and destroy" to obtain observable market inputs.

IAS 37, the staff believe it would not play a significant role in most instances for insurance contracts.

A4. Ultimately, when applied in practice, the results of the measurement may be quite similar or perhaps even the same. However, the means by which the measurement is achieved may be perceived by some as significantly different:

(a) Some believe that the use of a transfer notion provides rigor and discipline to the measurement.

(b) Others believe that the use of a transfer notion when markets do not exist creates a burden to the entity in proving that a market does not exist.

Appendix B

B1. The following appendix provides the latest draft language being considered by the IASB for the measurement being developed in the project to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, modified to exclude day one gains (the updated IAS 37 approach). That draft language is:

1 An entity shall measure a liability at the amount that it would rationally pay at the end of the reporting period to be relieved of the present obligation.

2 The amount that the entity would rationally pay to be relieved of an obligation is the lowest of:

(a) the [value the entity would gain if it did not have to fulfil] the obligation;

(b) the amount that the entity would have to pay to cancel the obligation; and

(c) the amount that the entity would have to pay to transfer the obligation to a third party.

The IASB is still finalizing the wording of 2(a). The wording will emphasize that the amount (a) reflects the fact that the entity will fulfil the obligation itself and (b) includes not only the expected present value of the cash flows but the full amount the entity would rationally pay to be relieved of the obligation.

3 In practice, entities are unable to cancel or transfer many liabilities within the scope of IAS 37. If there is no evidence that the entity could cancel or transfer the present obligation for a lower amount, it measures the liability at the [value the entity would gain if it did not have to fulfil] the obligation.

B2. At its meeting in April 2009, the IASB discussed guidance on how an entity would measure the [value the entity would gain if it did not have to fulfil] an obligation. The amount would be estimated taking into account:

(a) the outflows of resources expected to be required to fulfil the obligation;

(b) the time value of money; and

(c) the effects of uncertainty about the amount or timing of the outflows of resources.

Elements (a) and (b) are taken into account by estimating the 'expected present value' of the outflows required to fulfil the obligation. Factor (c) is taken into account by adjusting the expected present value for risk.