

## **IASB SUMMARY OF IASB PROPOSALS ON INSURANCE CONTRACTS – MAJOR INSURANCE INDUSTRY ISSUES**

### **1 Background**

1.1 The IASB issued the DP in May 2007 and it is open for comment until 16 November. A copy can be downloaded from the IASB website at [www.iasb.org](http://www.iasb.org).

1.2 The IASB's DP is the first step in phase 2 of its insurance project. Phase 1 culminated in the issue of IFRS 4 *Insurance Contracts* in March 2004. The main purpose of IFRS 4 was to exempt insurance contracts from the requirements of IAS 8 to enable insurers to continue their existing (and largely regulatory-based) accounting policies on adoption of IFRS. The DP is the IASB's first attempt at consideration of measurement and recognition issues for insurance liabilities.

1.3 The ASB has previously addressed life assurance accounting, in FRS 27 'Life Assurance' (issued in December 2004). Following the issue of this standard, it presented a report to HM Treasury on life assurance accounting, which set out several recommendations to the IASB on the areas that needed consideration in the insurance project. The conclusions from this report are set out in Appendix B. The full report to the Treasury is available from the ASB website at [http://www.frc.org.uk/images/uploaded/documents/Life\\_Assurance\\_Report\\_to\\_Treasury-final.pdf](http://www.frc.org.uk/images/uploaded/documents/Life_Assurance_Report_to_Treasury-final.pdf).

### **2 Implications of the proposals for insurance and non-insurance businesses**

2.1 Not only would these proposals have a wide-reaching effect on financial reporting for insurance businesses, but also many of the issues in the insurance project interrelate with other IASB projects and other areas of non-insurance accounting. Whilst insurance industry representatives have been,

and will continue to be, closely involved in discussing the proposals with IASB, the preliminary conclusions in the DP may have significant implications for other projects that apply to entities other than insurers.

2.2 The ASB is concerned to identify and consider all such interrelationships and ensure that any conflict between insurance accounting and non-insurance accounting is properly identified and considered. It has therefore issued a separate paper on implications for business sectors other than insurance, which it hopes will enable those outside the insurance industry to understand the wider implications (available from the ASB website at <http://www.frc.org.uk/asb/technical/projects/project0014.html> ).

2.3 The remainder of the current paper sets out the main elements of the proposals as they will affect insurance businesses, and notes some aspects that might give rise to concerns. However, the ASB has not yet reached any conclusions on the proposals. Those interested in insurance accounting are encouraged to respond to IASB on these proposals.

### **3 Measurement basis**

#### *The DP's proposals*

3.1 The bulk of the DP is devoted to issues relating to the measurement of insurance liabilities – in particular in chapters 3, 4 and 5 – and the preliminary views set out on these issues are fundamental to the rest of the document.

3.2 The DP (in chapter 3) proposes a current exit price valuation model for insurance liabilities. Although this is not described as a fair value, the DP does not identify any difference between the proposed current exit value and the fair value envisaged in the fair value discussion paper.

3.3 The proposed model is based on three building blocks:

- (a) a current unbiased probability-weighted estimate of the future cash flows;
- (b) adjustment for the effect of the time value of money using current market discount rates; and
- (c) an explicit and unbiased estimate of the margin required for bearing risk (a risk margin) and for providing other services (a service margin)

based on the margin a market participant would require for assuming the risk or performing the services.

3.4 Each of these three elements would be estimated based on the amount the insurer would have to pay to transfer the contractual rights and obligations under the policy to another insurer at the balance sheet date.

3.5 Acquisition costs relating to insurance contracts would be written off immediately (DP paragraphs 161 to 166); and no change is proposed to the current guidance (eg IAS 39) on accounting for assets held by insurers to back insurance contracts (DP paragraphs 176 to 182).

#### *Future cash flows*

3.6 The first building block is an estimate of the future cash flows arising from the insurance contract (DP paragraphs 34 to 62). This estimate of future cash flows would be required to:

- (a) be explicit;
- (b) incorporate in an unbiased way all available information about the amount, timing and uncertainty of all cash flows arising;
- (c) be as consistent as possible with observable market prices; and
- (d) correspond to conditions at the end of the reporting period.

#### *Discount rate*

3.7 The discount rate used (DP paragraphs 63 to 70) would need to be 'consistent with observable market prices for cash flows whose characteristics match those of the insurance liability' – ie not an asset-based rate. No detailed guidance on how this is to be determined is expected to be given. For short-term contracts, existing 'unearned premium' methods might be a sufficiently accurate approximation.

#### *Risk and service margin*

3.8 One input to the measurement is a margin. This comprises two elements:

- (a) a risk margin representing the additional amount that market participants would require for bearing the risk associated with the insurance contract (DP paragraphs 72 to 86)

- (b) a service margin, compensating the insurer for other services (such as investment management) that it provides (DP paragraphs 87 to 89).

3.9 The risk margin is not intended to represent a solvency margin – that is, it is not based on any particular level of assurance that the liabilities will not exceed the best estimate plus margin. In paragraphs 73 to 75 the DP also proposes that the margin is not to be seen as a ‘shock absorber’ or buffer against which claims in excess of expected amounts can be charged, but as compensation for bearing the risk based on the level required by market participants. That is, if an insurance liability increases beyond its initial estimate, the increase is not absorbed by the margin; rather, the liability is remeasured at the new estimate together with the full amount of the margin.

3.10 The risk margin cannot generally be observed (ie obtained from quoted prices or transactions), so must be estimated from an assessment of how market participants would measure the quantity of risk and the margin required per unit of risk (DP paragraphs 76 and 77).

3.11 The price for an insurance liability is generally observable only at inception, when the insurer and policyholder agree the premium for the contract. Some IASB board members consider that the risk margin should be calibrated to reflect the margin implicit in the pricing of the contract as issued by the insurer – that is, it should be set at the level that results in no gain or loss on inception (subject to a liability adequacy test at inception). This is referred to in the DP as Implementation A (paragraph 78). However, the majority of the board support the view that the margin should be based on an unbiased estimate of the margin another market participant would require if it took over the insurer’s contractual rights and obligations (although they accept that the price charged by the issuing insurer may be a useful reasonableness check on initial measurement). This is referred to as Implementation B. Under this approach, the insurer might recognise a gain or loss on inception if the margin implicit in the premium charged differed from the margin the insurer considers other market participants would require for the same amount of risk.

#### *Measurement attribute*

3.12 In paragraphs 92 to 95 the DP describes the measurement attribute based on the building blocks above as ‘current exit value’ – the amount the insurer would expect to have to pay at the balance sheet date if it transferred all its

remaining contractual rights and obligations under the insurance contracts to another party.

3.13 Paragraph 104 of the DP notes that the IASB has not yet determined whether this current exit value is, in fact, no different from the fair value defined in the discussion paper *Fair Value Measurements*. However, the IASB has not identified any significant differences between them.

## **4 Possible concerns over the proposals on measurement**

4.1 The proposals represent a consistent principled approach to measurement for insurance liabilities, particularly in respect of general insurance contracts (specific issues relating to life assurance contracts are considered later in this paper). However, there are several areas where conceptual concerns may arise (in addition to the concerns that the industry may have over the practicality of the proposals).

### *Current exit value*

4.2 In November 2006 the IASB issued a discussion paper on fair value measurement, setting out how fair value should be determined, wherever a standard calls for fair value measurement. This fair value discussion paper proposed that fair value should always be an exit value, based on the price the asset or liability could be transferred between market participants.

4.3 In its response to the fair value discussion paper, the ASB stated that it had long been of the view that, conceptually, financial reporting should evolve towards reporting more current values – that is, values that are relevant to the entity and reflect economic circumstances at the balance sheet date. However, the ASB went on to say that it did not believe that exit values were the most appropriate version of current values in all circumstances. The exit price model was based on the presumption that efficient markets were available, and that the price that a ‘market participant’ would transact at could be determined on a reasonably objective and consistent basis.

4.4 The DP’s proposals for current exit value as a measurement attribute would require insurers to use hypothetical transactions that rarely if ever occur – the transfer of contracts from one insurer to another – as the starting point for the valuation. As a result, it is more difficult to assess what factors the counterparty in such a hypothetical transaction might in fact take into account. In practice, therefore, it seems likely that the valuation would be

based on the pricing that would be used for actual transactions – contracts with policyholders – using either the entity's own pricing model (an entity-specific entry price) or a general "market participant's" pricing model (a non-entity-specific entry price).

*Exclusion of entity-specific cash-flows*

4.5 As the measurement attribute is an exit value, the cash flows on which it is based should exclude entity-specific cash flows, although (see DP paragraph 58) an insurer will often have no information on what another market participant would estimate the cash flows to be, other than the insurers own estimates. As a result, in many cases the valuation will retain entity-specific elements.

4.6 One area where insurers may be aware of differences between their own estimates and market participants' estimates is in relation to claims handling processes. These can vary significantly; an insurer may develop its own sophisticated procedures for detecting fraudulent claims, and pass some of the resulting cost savings on to policyholders in the form of lower premiums. Excluding entity-specific cash-flows could result in a loss being recognised on inception, with higher profits over the life of the policy as the benefits of the entity's own procedures are recognised.

*Initial profit and calibration*

4.7 The DP sets out two views on whether risk margins should be calibrated at inception to the risk margin implicit in the premium agreed with the policyholder (Implementation A) or not (Implementation B).

4.8 Under Implementation B, the risk margin is simply the best estimate of the risk margin market participants would require (although the actual premium charged by the insurer would be used as a reasonableness check on this). As a result, a gain or loss could arise on inception if the actual risk margin implicit in the premium charged is less than, or greater than, the estimated risk margin required by market participants.

4.9 Implementation A, in contrast, 'calibrates' the risk margin to that implied by the actual premium charged (taking into account acquisition costs). As a result a gain arises on inception equal in amount to the acquisition costs. A separate 'liability adequacy test' would be needed to ensure that losses were recognised on under-priced contracts.

4.10 Under Implementation A, the price per unit of risk is then unchanged for the remainder of the contract life, and risk margin is released as the units of risk in the contract reduce over time. Under B, the ‘price’ of a unit of risk is remeasured each period to reflect changes in what market participants would then require.

4.11 Further arguments for each of these implementations are set out in DP paragraphs 81 to 85.

4.12 Implementation A can lead to identical liabilities being measured differently, depending solely on the level of acquisition costs incurred. For example, an insurer may sell the same product at the same premium both through agents charging a commission, and through direct sales. Implementation A would result in a gain being recognised on the agent sales equal to the commission paid (in addition to other acquisition costs) that would not be recognised on the direct sales. As a result, the liabilities under the two contracts would be measured using a different measure of the risk margin.

4.13 On the other hand, Implementation B would lead to profits being recognised on inception based on a measurement of the liabilities that is not supported by observable prices or transactions.

#### *Discount rates*

4.14 The DP proposes that all insurance liabilities should be discounted. In the UK context, this does not appear to be a controversial issue (although it is more so in other jurisdictions).

4.15 The discount rate is intended to be a market rate that captures the characteristics of the liability. DP paragraph 69 states that “the discount rate should be consistent with observable current market prices for cash flows whose characteristics match those of the insurance liability, in terms of, for example, timing, currency and liquidity”. This seems too imprecise a formulation – particularly as one characteristic of the insurance liability – the insurance risk itself – is clearly not intended to be included.

4.16 Some might suggest that there is also a possible contradiction inherent in the proposal. Market participants might price a future liability on the basis of the investment return they could earn on the assets held to meet the liability – and this would apply even if there was no insurance risk.

4.17 DP paragraphs 229 to 232 (and Appendix H) set out the IASB's view that the measurement of the liability should take into account the credit risk – the current exit price of a liability reflects the risk of default. However, it notes in paragraph 232 that since policyholders are unlikely to take out a policy with an insurer they consider may not satisfy its obligations in full, the credit characteristics of an insurance liability are unlikely to have a material effect on the current exit value at inception.

### *Complexity*

4.18 An overriding concern is that the proposed measurement model introduces a high degree of complexity into insurance accounting – and thus that the 'black box' of insurance accounting will still remain. Although actuaries may be capable of modelling the exit value approach and producing the valuation required for financial statements, and it will be possible to describe the output of the black box as a current valuation of the insurance liabilities, it will be impossible to understand the significance of the assumptions that go in to the valuation process, the uncertainties underlying the valuation and the explanations for the changes in the valuation that arise from one period to the next other than in the fairly simplistic terms of the three building blocks proposed in the DP.

4.19 However, it may be argued that complexity is a necessary consequence of adopting any current value model for insurance, and that the benefit of more relevant current value information would outweigh the costs involved.

## **5 Unit of account issues**

5.1 Insurers have generally determined liabilities on a portfolio basis, treating similar contracts together. The DP proposes that in theory each contract should be measured individually – for example, the risk margin should be estimated based on the risk of a single contract rather than based on the risks of a portfolio, excluding the risk reduction that comes from holding contracts with offsetting risks. It is not clear how practical these proposals are.

5.2 The unit of account is also relevant if a liability adequacy test is required (if Implementation A of the current exit value model is adopted – see paragraph 54 of the DP). In theory, a liability adequacy test should be at the same unit of account level as the measurement itself – that is, at the individual



contract level. However, this must be offset by the practical implications of such a detailed test.

## **6 Beneficial policyholder behaviour**

6.1 One important area for insurance accounting, and one where it is often argued that ‘insurance is different’, is the treatment of what the DP describes as ‘beneficial policyholder behaviour’ (see DP paragraphs 121 to 160). In many cases the profitability of insurance business is dependent on policyholders continuing to pay premiums for a policy even though the insurer has no contractual right to demand payment – the policyholder is free to cancel at any time.

6.2 This is particularly relevant to life assurance. The insurer may incur substantial costs in entering into the contract (‘acquisition costs’), including commission payable to intermediaries. These costs are only recovered out of the profitability of the contract over several years, even though the policyholder may terminate the contract at any time – in practice, most policyholders do continue to pay premiums over the long term, and expected lapse rates are incorporated into the pricing of the policies.

6.3 The issue does not relate solely to acquisition costs. DP paragraphs 129 – 133 set out a highly simplified illustration of a group of contracts that give the policyholder the right to renew at the existing premium. Policyholders who have become unhealthy before the renewal date have a high incentive to renew, and these contracts will give rise to losses for the insurer. However, these are expected to be offset by gains on renewals by healthy policyholders. At the end of the first year, the insurer has received more in premiums than it has paid in claims, but is committed to insure policyholders for the second year even if they have become unhealthy, and overall expects claims in the second year to exceed premiums received in that year (so that over the two years the insurer breaks even on these policies). Four possible treatments at the end of the first year are discussed:

A: ignore the potential losses in the second year, and record a gain for the first year;

B: provide for the expected loss-making renewals in the second year, without offsetting the expected profitable renewals;

C: provide for all loss-making renewals in the second year, again without offsetting the expected profitable renewals;

D: provide for the expected loss-making renewals in the second year, together with the expected profitable renewals.

6.4 The DP argues for approach D, largely on the grounds that this is more useful information and is consistent with the pricing of the contracts. It is also argued that this represents the price that the insurer would agree to transfer the contracts to another party (the basis of the 'exit value' measurement that is proposed).

6.5 The DP therefore proposes that in measuring the liability the insurer should take into account those future premiums that the policyholder must pay in order to maintain insurability on the agreed terms. This is justified in conceptual terms as being part of the value of the intangible 'customer relationship' asset; but the DP does not propose that this intangible asset should be recognised separately but as a reduction in the value of the liability.

#### *Possible concerns*

6.6 This approach represents a practical solution to the difficulty of contract renewals, and avoids the loss on inception that can otherwise arise. However, it may be criticised as being conceptually weak – it is unclear why only part of the customer relationship should be recognised in this way (rather than attempting to value the whole customer relationship), and to treat the intangible asset as a reduction in the value of the liability seems odd – and is justified in the DP largely on the basis that separate identification and recognition of this would be unduly costly. The DP does not address whether this 'asset' meets the Framework's definition of an asset or its asset recognition criteria.

## **7 With-profits life assurance**

7.1 The DP does not address the issues of participating contracts (which include with-profits life assurance) in great detail. (The preliminary views are in paragraphs 254 to 258 of the DP.) The DP envisages a 'prospective' calculation under which the measurement of the liability would be based on all cash flows under the contract, including future premiums (but only if they met the 'guaranteed insurability' test referred to above), and future bonuses

(‘policyholder dividends’) that related to these, but only to the extent that they represented legal or constructive obligations.

7.2 However, the DP does not discuss in detail what constitutes a constructive obligation (merely quoting the proposed definition and guidance in the ED of amendments to IAS 37); although it states that the prospective measurement cash-flows should include legal or constructive obligations that exist at the reporting date, it does not consider to what extent obligations that are conditional on future premiums being paid, or future management actions (such as an intention of increasing bonuses to distribute part of the ‘estate’) form part of the obligation at the reporting date.

7.3 The need for measurement to take account of options and guarantees is noted but the implications are not considered. Nor does the DP address the effect of ‘management actions’ in the prospective measurement of the liabilities, and whether it is appropriate to take expected actions into account in determining the amount expected to be paid to policyholders under specified scenarios.

7.4 More conceptually, the DP does not consider how amounts in the life fund in excess of policyholder liabilities (the fund for future appropriations, or FFA) should be presented in the financial statements – whether these amounts represent equity (but not shareholders’ funds), or whether they should be treated as liabilities.

7.5 These issues, which the Board considered at length in its development of FRS 27 and the subsequent report to the Treasury, are complex and fundamental to the reporting of life assurance.

7.6 On unit-linked policies, the IASB notes that mismatches can arise when the assets held to match these policies are not recognised under IFRS – for example, the insurer’s own shares (which must be treated as treasury shares and deducted from the insurer’s equity, not held as separate fair valued assets). The DP proposes no solution to this.

## **8 Unbundling**

8.1 The DP proposes that insurance contracts that contain a deposit element should be unbundled if the components can be measured separately on a basis that is not arbitrary, for the purposes of measurement (DP paragraphs 220 to 228). It also considers whether premiums should be unbundled and

only that element relating to the insurance element of the contract shown as insurance revenue in the profit and loss account.

8.2 Unbundling would have significant practical consequences for insurance entities. In addition the intention of the test based on 'arbitrary measurement' may need further clarification.

## **9 Capital disclosures**

9.1 When it developed FRS 27, the ASB concluded that it was essential that a life assurance business provided full details of its capital position – both the regulatory capital targets it was required to meet, and the capital available to meet those targets. Particularly important was information on the extent to which capital held in one part of a group was available, or not, to meet capital requirements imposed on another part of the group. For example, there may be a surplus held in a UK life fund that could not be transferred to meet capital requirements of the general insurance business.

9.2 The DP addresses accounting for insurance *contracts*, not insurance *entities*, and as such does not discuss disclosures of this nature (which relate to the entity as a whole). IAS 1 (as amended in 2005) requires disclosures relating to capital that are in broad terms similar to those of FRS 27, but because these are applicable to entities generally and not specific to insurance entities, they do not address specific insurance-related issues and do not result in the same level of detailed disclosure that the ASB considered necessary in FRS 27.

## **10 Conclusion**

10.1 The IASB's proposals in the DP would have a wide-ranging effect on financial reporting for insurance business, and give rise to a number of possible concerns. The ASB has not yet reached its conclusions on these proposals, and will continue to hold discussions with interested parties to assist it in developing its views. It encourages constituents to consider both the insurance and wider implications of the proposals, and to respond with their views to IASB.

## **APPENDIX**

### **Extract from ASB Report to HM Treasury: Financial Reporting for Life Assurance (June 2005)**

#### **Part II - Conclusions**

#### **6 Conclusions on future directions of life assurance accounting**

6.1 The ASB has addressed above some of the more significant issues that have been identified from its work on life assurance. In summary:

- (a) the present basis of life assurance accounting in the UK remains in need of improvement despite the progress made by FRS 27;
- (b) in the short term, further progress in extending FRS 27 to more entities and more transactions would be facilitated by the extension of the FSA realistic liability approach to all life funds and all types of business;
- (c) other than pursuing that possibility, the ASB should support the IASB in its comprehensive project on insurance accounting.

6.2 Major issues relating to life assurance accounting that will need to be addressed by the IASB arise in the following areas:

- (a) measurement of liabilities –
  - (i) whether undeclared discretionary future bonuses on with-profits policies always fall within the definition of constructive obligations consistent with other liability recognition principles;
  - (ii) the subjectivity of liability valuation, whether based on prospective or retrospective approaches, and the fact that it takes account of future management intentions in relation to action that could be taken in certain circumstances to reduce liabilities to policyholders or reallocate benefits between different groups of policyholders;
  - (iii) the consistency of a stochastic modelling approach to valuation of options and guarantees with a fair value measurement principle;
- (b) profit recognition – whether profit recognition based on changes in assets and liabilities is able to resolve the many complex issues that

arise, given that the measurement of liabilities incorporates many subjective and discretionary elements and in some circumstances assumes a particular basis for recognising income;

- (c) equity versus liability classification – whether the existing Framework distinction between liabilities and equity fits well with the residual rights of policyholders and shareholders to the estate in a life assurance business;
- (d) embedded value methodology and disclosures –
  - (i) whether there is a conflict between an embedded value approach and the IASB conceptual framework;
  - (ii) whether the embedded value approach could provide useful supplementary information;
  - (iii) whether embedded value disclosures can be developed to provide information indicating the timing of cash flows from the life fund.

6.3 The IASB should also consider the development of disclosures explaining the risks and uncertainties faced by the life assurer and the role played by the various categories of a life assurer's capital in relation to those risks, along the lines of the quantitative and narrative disclosures relating to capital position required by FRS 27.