



Phase II Discussion Paper

May 2007

Introduction

This IFRS Insurance Alert ('the Alert') summarises the key elements of the International Accounting Standards Board's 'Discussion Paper: Preliminary views on insurance contracts' (www.iasb.org).

The Alert also highlights the differences between the IASB's proposals and the views of two industry groups that have put forward their own parallel blueprints for insurance contract accounting (the Group of North American Insurance Enterprises (GNAIE) and CFO Forum), along with the IFRS model under IAS 39.

The content of the Alert seeks to follow the content of the discussion paper (150 pages) and its appendices (another 83 pages) as closely as possible, though naturally when abridging such a long document not all areas have been covered, while some sub-sections have been married together.

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Chapter 1: Executive summary and background

On 3 May 2007, the IASB published its long-awaited discussion paper setting out its preliminary views on the measurement and recognition of insurance contracts and financial instruments with discretionary participating features, under Phase II of their project to issue an IFRS for insurance contracts.

The first set of proposals for an IFRS for insurance contracts dates as far back as 1999. In 2002, the IASB split its project into two phases. Phase I was completed in March 2004 with the publication of IFRS 4, a temporary expedient focused on contract classification and disclosure. The current discussion paper is the latest stage of extensive analysis and debate from Phase II of the insurance contract project. To build the maximum consensus around the new IFRS, the IASB started Phase II with a clean slate; the only restrictions are the parameters set by the IASB's 'Framework for the Preparation and Presentation of Financial Statements'. The input has included analysis by the Insurance Working Group (set up in 2004), which brings together senior representatives of the insurance industry and other interested parties.

The discussion paper focuses on the insurance contracts currently covered by IFRS 4. It forms the basis of public consultations that will run until 16 November 2007. The feedback from these consultations will aid the IASB in developing firm proposals for an exposure draft that is due to be published towards the end of 2008. Allowing for a further period of public consultation, the IASB expects the new standard to be in place in 2010. The proposed effective date for the new IFRS is not known yet.

The measurement model

The key elements of the proposed measurement model are as follows:

- **Single approach** to account for all insurance contracts based on three building blocks:
 - a) An explicit, market-consistent, unbiased, probability-weighted current estimate of future cash flows;
 - b) A discount rate based on market interest rates to discount these cash flows; and
 - c) An explicit and unbiased estimate of a margin that another party would require to bear risk (risk margin) and to provide services (service margin) if there are any.

This model applies to all life and non-life insurance and reinsurance contracts. The expected value would be based on an evaluation of all possible outcomes, which could create additional demands on data and modelling systems. Even if these capabilities are available, insurers will need to ensure that the analysis is up to an auditable standard.

- The IASB tentatively favours the measurement of these three building blocks using a **current exit value** model (i.e. assuming a hypothetical transfer of the contract to another party), rather than using the premium ('current entry value') as its basis of valuation. As the current exit value is not linked to the premium received from the policyholder, it could potentially lead to an initial gain at the inception of the contract. In both entry and exit value models the insurer could recognise day one losses if it under-prices its premiums.
- **Current market discount rates** need to be based on market-risk-free interest rates matching the characteristics of the contractual cash flows, including timing, currency and liquidity. The insurers' investment strategy is not relevant.
- Contracts with insurance and investment elements may need to be unbundled and measured separately (Phase II for insurance and IAS 39/IAS 18 for investment). **Unbundling** is limited to circumstances where the components are not interdependent and can be split on a basis that is not arbitrary.
- In the current exit value model, the explicit **risk margin** reflects the allowance for uncertainty that a nominal market participant would require to take on the transferor's remaining contractual rights and obligations. In practice, this will require a 'proxy' for market-observable valuation based on either a 'percentile' or 'cost of capital' approach, broadly in line with the current debate over EU Solvency II. The IASB does not express a preference for a particular method.
- The **service margin** reflects the cost to the insurer of transferring to another party the remaining portion of services provided as part of the contract, such as investment management. Both the risk and service margin would need to include a profit element that a third party would demand for bearing those risks and delivering those services.
- **Acquisition costs** are expensed as incurred under the current exit value approach. The current exit value basis may produce income that would offset acquisition expenses if there are premiums (already received or expected in the future) that policyholders must pay to maintain their right to 'guaranteed insurability'.
- **Guaranteed insurability** is the policyholders' right to receive insurance coverage at a price that is contractually constrained without reconfirming their risk profile. All future premiums that pass this test are included in the current value measurement.
- **Policyholder participating benefits** can be recognised and measured as a liability based on the existence of either a contractual or a constructive obligation. The concept of what is a constructive obligation is under review by the IASB in the context of its other projects on IAS 37. The application of constructive obligation to the definition of a liability is likely to have an impact on the IASB debate on its project on debt/equity classification.

All to play for

The preliminary views set out in the discussion paper are tentative and therefore allow considerable room for further input and development. Contentious areas that remain under debate within the IASB itself include whether the adoption of a current exit value should be confirmed or not. From the industry side, the European CFO Forum and the Group of North American Insurance Enterprises (GNAIE) have also set out proposals that run counter to the discussion paper in a number of key areas (see Appendix 1 for details). While the differences between the CFO Forum and the IASB are significant (including gains at inception), they are largely conceptual. The differences between the GNAIE and IASB are perhaps more fundamental. In particular, the GNAIE advocates separate principles for life and non-life contracts. It is also opposed to the discounting of non-life claims reserves.

The IASB's proposals break new ground in a number of key areas and could have an important bearing on a number of other IFRS projects, including revenue recognition and the classification of instrument as debt or equity.

As part of its commitment to convergence with IFRS, the US Financial Accounting Standards Board (FASB) intends to issue an 'invitation to comment' that includes the IASB's discussion paper. The FASB will consider the responses in deciding whether to pursue convergence in accounting for insurance contracts.

Making views count

It is clearly important that insurers understand the full implications of these proposals for their business and, based on this appraisal, take the opportunity to comment. While there will be further opportunities for comment following the publication of the exposure draft, the current consultation period offers the best chance to influence the fundamental principles and key practical details of the eventual IFRS Phase II standard.

Summary of main text

Chapter 2: Recognition and derecognition

The IASB proposes that insurance assets and liabilities should be recognised on the balance sheet when the insurer becomes party to the contractual provisions. Insurance liabilities (or parts thereof) should be derecognised from the balance sheet when the obligations are extinguished (i.e. settled, cancelled or expired). The discussion paper does not deal with the derecognition of insurance assets.

The proposals set out in the discussion paper would not change the current basis for recognition and de-recognition set out in IFRS 4.

Chapter 3: Measurement – core issues

3a – Measurement attribute

The discussion paper favours a single approach to the measurement of insurance liabilities based on the current exit value. This approach would be used for all insurance liabilities regardless of the type of risk transferred (e.g. life and non-life), the type of issuer (primary insurer or reinsurer), the form of policyholder's participation (participating, non-participating, unit linked etc), the type of company (e.g. stock corporation or mutual entity) or duration (e.g. long- or short-term).

The current exit value is based on the following three building blocks:

1. An explicit, unbiased, market-consistent, current probability-weighted estimate of all future cash flows under the contract;
2. A market-based discount rate to reflect the time value of money;
3. An unbiased estimate of a margin to reflect the compensation required by other market participants (mainly but not limited to the bearing of risk).

The discussion paper sets out two main alternative methods for valuation: current exit value (IASB's preference) and current entry value. The entry value is based on the transaction price charged to a policyholder. The exit value is based on the amount an insurer would need to pay another entity to take on all its remaining contractual rights and obligations immediately, irrespective of the premium charged. Net losses at inception would be recognised in both models if economically justified. Only the current exit value model would permit a gain on day one.

The main difference between the two implementation methods relates to the margin. The entry value would place more emphasis on the transaction price charged to a policyholder to determine the margin, rather than estimating the margin with reference to a hypothetical transfer of the liability to another entity, as under the exit value.

As a policy may be issued at a price that is not sufficient to cover expected claims (under-pricing), for reasons such as cycle downturns, entry value would require a liability adequacy test (LAT). In the case of under-priced contracts, the LAT might require recognition of net losses immediately.

According to the IASB, exit value provides more consistent results than entry value. For example, it believes that the recognition of net losses in weak business cycles (under-pricing) would be inconsistent if there is no opportunity to realise profits in hard market cycles. Furthermore, the deferred gains in such situations would not meet the definition of a liability within the Framework. Finally, the LAT would not be required.

While the exit value approach is tentatively favoured in the discussion paper, the IASB is prepared to consider arguments in support of the current entry value, especially as the current preference has been reached by the narrowest of votes. Some of the stakeholders that have expressed a view have tended to favour approaches similar to the current entry value (GNAIE and CFO Forum – see Appendix 1), while others would prefer models similar to the current exit value model (International Association of Insurance Supervisors – IAIS).

Other conceptually different approaches had been discussed in the early stage of the current project (e.g. cost-based approaches). However, the two versions of current value are the only alternatives fully set out in the discussion paper.

3b – Initial measurement

The measurement should take account of the uncertainty in timing and amount of estimated future cash flows ('risk margin'). The IASB does not intend the risk margin to be a cushion for the unexpected but rather a guide to help users of accounts gauge the relative uncertainty associated with the future cash flows.

Under the current exit value approach, the risk margin is based on an estimate of what a third party would require to assume the risk, rather than being calibrated to the premiums. However, the premiums would still provide a sense check in the event that the estimated margin differs significantly from the implied margin built into the premium paid by the policyholder.

The risk margin is portfolio- rather than entity-specific. This means that the risk margin should reflect the pooling of liabilities, but not the diversification of risks across the insurer's business or the negative correlation that different portfolios could provide.

The IASB does not wish to prescribe a specific method for developing risk margins in relation to its preferred current exit value approach. Instead, it has simply opted to explain the attributes of valuation techniques that would make them consistent with the principles of the approach and would provide useful information to users of accounts (see Appendix 2 for more details).

3c – Service margins

The current exit value not only includes a risk margin, but also a service margin that the insurer receives for rendering services such as investment management. Measurement at each reporting date would reflect the amount a market participant would demand to provide the remaining services under the contract.

In keeping with the approach to bearing risk described in Chapter 3b, the current exit value model allows the recognition of income on day one if an insurer is able to receive fees higher than the market participants would demand. Accordingly, it would recognise a loss if the expected fees for that service are lower than the price paid to transfer the same obligation to another party.

This approach is applied throughout the life of the contract. If at a later stage market participants would require a higher margin than previously estimated, then the current exit value of the liability would increase accordingly. This differs in principle from IAS 18. While IAS 18 focuses on the stage of completion, Phase II would look at the compensation payable to lay off the remaining service obligations.

The service margin is a new concept in insurance accounting. The method of measurement is a move away from a traditional discounted cash flow (DCF) approach that would take account of the contractual amount that would have been earned without regard to what could be received elsewhere in the market. There may, therefore, be differences with existing evaluation techniques that use the DCF approach, such as embedded value.

3d – Discount rates

The discount rates should be consistent with observable market prices for cash flows whose characteristics match those of the insurance liability in terms of timing, currency and liquidity. The IASB does not intend to give further guidance on how appropriate discount rates should be derived in practice.

The IASB sets out in detail the reasons behind its decision to discount non-life claims liabilities. The main reasons cited are:

- Insurers and investors take account of the timing of cash flows;
- Undiscounted amounts create opportunities for transactions (e.g. financial reinsurance);
- All other comparable liabilities are discounted under IFRS;
- Discount rates and the timing of future cash flows can generally be estimated in a sufficiently reliable and objective way and at a reasonable cost;
- Explicit discounting requires a more transparent approach to other variables (e.g. inflation), which delivers a higher quality of accounting.

Chapter 4: Policyholder behaviour, customer relationships and acquisition costs

4a – Guaranteed insurability test

The unbiased estimate of the future cash flows from an insurer's contractual rights and obligations includes the insurer's right to collect and benefit from future premiums specified in the contract.

The insurer would recognise future premiums using three criteria. The first two criteria require future premiums to be included when:

- There is an unconditional contractual obligation to stand ready to accept premiums whose present value is less than the present value of the resulting additional benefit payments;
- The insurer has an unconditional contractual right to enforce payment of the premiums.

The third criterion is probably the most important of them all, because it deals with policyholder behaviour.

When premiums depend on policyholder behaviour the insurer does not control them and therefore they would not normally be recognised under IFRS. However, the IASB observed that insurers do have control over the customer relationship associated with the contracts they issue. In particular, a portion of this customer relationship arises from the future premiums policyholders must pay to guarantee continued coverage without confirmation of their own risk profiles, at a price that is contractually constrained.

In the IASB's view, the asset arising from this portion of the customer relationship is so closely associated with the existing contract that recognition is justified despite being an internally generated asset. The IASB also believes that this close association justifies the accounting of the asset together with the contractual liability, as the costs of accounting them separately would exceed the benefits of doing so.

This crucial third criterion for the recognition of future premiums is defined as the guaranteed insurability test. If review/confirmation of the policyholder's risk profile is required at any point, then the arrangement would become a new contract for accounting purposes. The IASB has stated that it does not intend to extend these conclusions to options in contracts other than insurance contracts.

The following types of future premiums do not create a right to benefit and would therefore not fall under the guaranteed insurability criterion:

- Payment of premiums for a deferred annuity contract in the accumulation phase when the basis for the annuitisation rate is not yet set;
- Premiums to retain other contractual features (e.g. minimum crediting rates).

4b – Acquisition costs

The discussion paper proposes that the insurer should recognise acquisition costs as an expense when it incurs them. However, the recognition of future premiums that pass the guaranteed insurability test means that these premiums would reduce the measurement of the liability. This is because the insurer would include this portion of the customer relationship asset in the liability measurement.

Under the current exit value model, this lower liability may result in income on initial measurement that could be greater than the acquisition costs. In this case, the insurer would recognise a day one gain. Accordingly, it will recognise a day one loss if the income from future premiums is lower than the acquisition costs incurred. However, under the current entry value model, the recognition of a net day one gain is prohibited and a day one loss is only possible when the LAT requires it.

4c – Business combinations and portfolio transfers

Under IFRS 3, the cost of a business combination is allocated on the basis of the fair values assigned to individual assets acquired, and liabilities and contingent liabilities assumed. These fair values are determined at the acquisition date. Insurance contracts are covered by the IFRS 3 requirements on fair value measurement. However, IFRS 4 permits the use of expanded disclosure, under which the fair value of the insurance contract is presented as two components:

- a) A liability measured according to existing accounting policies for insurance contracts (the recorded value); and
- b) An intangible asset, defined as the difference between the contract's fair value and its recorded value.

The use of expanded presentation is also available for a block of insurance contracts acquired in a portfolio transfer.

Under current exit value, the transfer of contractual rights and obligations to another entity may include cash flows that represent a portion of the customer relationship arising from guaranteed insurability. As the IASB has not yet concluded whether current exit value is similar to fair value, there may be differences that would require the retention of expanded presentation.

Chapter 5: Measurement – other issues

5a – Unit of account

The IASB has noted that the 'expected value' is seen by some as being more relevant to a portfolio than to an individual contract.

However, in its view the expected (probability-weighted) cash flows from a portfolio are equal to the sum of the expected cash flows of the individual contracts and the choice of a unit of account at a portfolio level is irrelevant for this component of its proposed measurement basis.

The IASB noted that insurers pool, hedge and diversify their insurance risks to minimise adverse fluctuations. If valuation is based on all available information about the portfolio, then the same statistical evidence is used, regardless of whether the portfolio is measured contract-by-contract or at a higher level of aggregation. However, the unit of account could affect the risk margin under some circumstances. In particular, a small portfolio may be more susceptible to random fluctuations than a larger one.

For this reason the IASB decided that the determination of risk margins will be based on a unit of account equal to a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio: a notion already used in IFRS 4 in the context of the liability adequacy test requirements.

This choice allows for the effect of pooling of risks (a characteristic specific to a portfolio) in the accounting measurement but not for the effects of diversification or negative correlation of risks (characteristics that are specific to an entity rather than a portfolio).

5b – Reinsurance

Inwards

The IASB proposes that liabilities from reinsurance contracts issued should be accounted for in the same way as direct insurance contracts at current exit value.

Outwards

The IASB proposes that reinsurance assets should also be measured at current exit value. The reinsurance asset comprises the reinsurer's share of the insurer's liability, i.e. the reinsurer's share of the discounted expected cash outflows resulting from the underlying direct insurance contracts, along with the reinsurer's share of the risk margin.

In the straightforward case of a 50% proportional reinsurance treaty, the reinsurance asset would comprise a 50% share of the discounted expected cash outflows and a 50% share in the respective risk margin.

However, there may be different carrying amounts in the cedant's and the reinsurer's accounts (no mirror accounting). One possible reason stems from the fact that the size of risk margin is affected by the relative size of the unit of account. Therefore, if the reinsurer bundles together the books of business of different insurers, its liabilities may be lower than the reinsurance asset. Moreover, a reinsurer might be better informed and therefore able to make a more precise estimate of the money needed to settle the liabilities.

Impairment of reinsurance assets

The IASB proposes that the carrying amount of reinsurance assets should be reduced by the expected present value of (future) losses from defaults or disputes with reinsurers. There would also be a further reduction to reflect the margin that market participants would require to compensate them for losses that might exceed this estimate ('expected loss' approach).

Non-overlapping periods of coverage

The IASB proposes that a cedant should recognise at current exit value its contractual right, if any, to obtain potentially favourable reinsurance rates in relation to contracts that it has not yet issued. In practice, the impact on current exit value may not be material in many cases.

5c – Unbundling

The discussion paper looks at whether or not deposit components in an insurance contract should be unbundled for the purposes of recognising and measuring the liability. It does not address the question of whether premiums should be split into revenue, deposit and service components.

The discussion paper proposes that:

- The Phase II standard should apply to the whole contract if the components are so interdependent that they could only be measured separately on an arbitrary basis;
- If the components are not interdependent, IAS 39 should apply to the deposit element and the Phase II standard should apply to the insurance element; and
- If the components are interdependent but may be measured separately on a basis that is not arbitrary, IAS 39 would apply to the deposit element. The whole contract will continue to be accounted for under the principles of the Phase II standard, with the insurance element measured as the difference between the amount for the whole contract and the deposit element.

5d – Credit characteristics of insurance liabilities

The discussion paper proposes that the current value of an insurance liability should always reflect its credit characteristics. These can differ from the credit standing of the insurer as a whole, for example on account of the existence of an external policyholder protection scheme and/or the fact that insurance liabilities rank ahead of other obligations in case of the insurer's insolvency.

The IASB does not believe there are conceptually valid arguments to avoid the inclusion of credit characteristics when insurance liabilities are initially measured. This approach has been adopted in all other similar liabilities under IFRS. However, the IASB believes that the credit characteristics are unlikely to have a material effect on the current exit value at inception, as a policyholder is unlikely to buy cover from an insurer that it believes may not meet its liabilities. This assessment is also based on the consideration that most insurers in developed markets are strongly regulated and therefore have sound credit standing.

The IASB observes that it would be logically inconsistent if the same characteristics were not included in the subsequent measurement of insurance liabilities when they are included at day one.

Chapter 6: Policyholder participation

6a – Participating contracts

The IASB proposes that entities should recognise a liability for participating contracts if, and only if, there is a legal or a constructive obligation for the insurer to pay policyholder dividends. Whether or not the existing guidance on what constitutes a constructive obligation is appropriate and sufficient is the main focus of the paper's examination of this issue.

The IASB analysis considers three broad steps in the operation of participating rights, which may occur in the same accounting periods or in different periods:

- Step 1: The identification of a distributable amount that the insurer uses to determine the allocation to policyholders;
- Step 2: The allocation of the distributable amount to policyholders as a group creates a policyholder surplus that is not yet attributed to each individual policyholder; and
- Step 3: The determination of the individual policyholder dividend.

Using this broad analysis and drawing on the Framework's current definition of a liability, the IASB has considered the critical question of whether or not the insurer has a 'present obligation' under the participating contract. Drawing on further guidance from the existing IAS 37, as well as on the exposure draft proposing certain changes to IAS 37 (published in 2005), the IASB believes that the insurer would need to consider the presence of a legal or constructive obligation in all scenarios across various possible sources:

- a) The policyholder surplus recognised in the financial statements;
- b) Amounts that are included in the financial statements but will not be included in the policyholder surplus until a future period (for example unrealised gains when the policyholder surplus is based on realised gains only); and
- c) Future premiums included because they pass the guaranteed insurability test.

These scenarios would also apply to financial instruments with participating rights, and it is likely that the IASB will consider its decision for these instruments when it deals with its project on debt/equity classification.

6b – Universal life contracts

Universal life contracts are common in the US. Similar products are now being introduced in Europe.

These products tend to give the policyholder considerable freedom to vary premiums. Typically the premiums paid are added to a policyholder account. Life cover is provided as long as the fund is able to pay the death benefit and other charges. There might be cases where death benefits are paid even if the fund is exhausted ('secondary guarantees'). Interest is added to the account according to the balance. The crediting rate may either be set by the insurer (sometimes including minimum crediting rates) or it could be based on the return of a pool of specified assets.

The IASB proposes that estimates of the crediting rates should reflect an expectation for each of the estimated scenarios and not merely provide the minimum contractual requirement. The question of future cash flows is linked to the discussion in Chapter 4. Whereas many traditional life contracts are deemed to meet the guaranteed insurability test (see Chapter 4), this is less clear in relation to universal life products on account of the policyholders' freedom to vary premiums over the time. The IASB intends to carry out further research on how the guaranteed insurability test works for these contracts.

6c – Unit-linked contracts

In certain insurance contracts some or all of the policyholder benefits are determined by the price of units in an internal or external fund, i.e. a determined pool of assets. Such contracts are examined in the discussion paper as unit-linked contracts, with the pool of assets called separate account assets.

The paper identifies and analyses a number of potential difficulties relating to unit-linked contracts and separate account assets. The first and fundamental question is whether separate account assets (and related liabilities) should be recognised in an insurer's financial statements. The IASB has yet to come up with a preliminary view. Instead, the paper examines three possible approaches to dealing with the recognition of separate account assets:

- a) Not to recognise them and the associated portion of the insurance liability;
- b) To recognise and present these assets as separate items in one single line on the face of the balance sheet; or
- c) To recognise the assets without presenting them separately in the face of the balance sheet.

The IASB asks respondents for their view and will consider this question further in its project on consolidation.

The second key issue relates to the fact that in most existing scenarios separate account assets are typically measured at fair value, with the same approach used for the related liabilities. However, there are situations where the assets cannot be measured at fair value, or where changes in the fair value would not affect the profit and loss account, thus generating a potential accounting mismatch. The IASB would prefer to eliminate any potential mismatches. However, it does not believe this can be achieved without creating inconsistencies with other IFRSs, and asks respondents for their views.

Chapter 7: Changes in insurance liabilities

The discussion paper looks at whether an insurer should be required to present separately any specified components of the change in the carrying amount of its insurance liabilities. This relates closely to the question of whether premiums should be presented as revenue, deposit receipts or a mix of both.

The IASB has yet to reach a preliminary view at this stage. However, the discussion paper sets out certain minimum requirements. While some of these are common under existing cost accounting models (e.g. claims and expenses, policyholder participation), some are introduced because of the use of current value models such as unwinding of discount etc. In addition to traditional premiums and claims analyses, an insurer could provide some margin analyses to disclose sources of profit. The way to present the sources of profit depends on the final presentation of premiums.

Finally, the discussion paper explores six different approaches to performance reporting:

1. Non-life insurance, traditional presentation;
2. Life insurance, traditional presentation;
3. Non-life insurance, modified presentation without Deferred Acquisition Costs ('DAC');
4. Life insurance, modified presentation without DAC;
5. Fee presentation, all premiums as deposits, similar to US GAAP for universal life contracts;
6. Margin presentation, all premiums as deposits, similar to embedded value and to the 'sources of earnings' approach under Canadian GAAP.

Examples on the six methods are given in Appendix G of the discussion paper.

Industry views and summary of selected appendices

Appendix 1 Alternative industry views (not included in discussion paper)

The development of Phase II has naturally attracted considerable interest from industry groups. Contributions to the debate include last year's publication of new and elaborated principles by the European CFO Forum (www.cfoforum.nl) and the Group of North American Insurance Enterprises (GNAIE – www.gnaie.net).

The main point of contention between the IASB and its industry stakeholders is the approach to measurement, with the IASB favouring exit value and the CFO Forum and GNAIE advocating entry value. A number of further and often related issues have also come to the fore:

- The two industry groups would wish to prohibit gains at inception (see item 4 below);
- The two industry groups would prefer a single entity-specific margin rather than the separate risk and service margins advocated by the IASB (see item 5 below);
- The GNAIE advocates separate measurement models for life and non-life insurance (see item 1 below);
- The two industry groups believe that credit standing should not affect the discount rate after initial valuation (see item 13 below);
- The GNAIE is opposed to the discounting of claims liabilities (see item 6 below);
- Differences of opinion among the two industry groups and the IASB have emerged in relation to the accounting for participating contracts (see item 15 below).

	Industry Proposals*	IASB preliminary decisions
1	Separate approaches to life and non-life insurance GNAIE proposes different principles for life and non-life insurance. The CFO Forum proposes a single model, but has yet to determine how their principles apply to reinsurance contracts.	Single approach for all types of insurance contract (including life, non-life and reinsurance).
2	Release from risk The risk profile of a policy determines the pattern of profit recognition.	The measurement of the liability includes a risk margin. As the insurer is released from risk, the risk margin is reduced and the insurer recognises income.
3	For many short-duration insurance policies, the 'release from risk' approach may be closely approximated by the unearned premium approach.	The unearned portion of the premium received may sometimes be a reasonable approximation to the required measurement if the pattern of risk is linear, the contract is not likely to be highly profitable or highly unprofitable, and circumstances have not changed significantly since inception.
4	Initial measurement On initial measurement, there should be no gains or accounting losses.	A net gain or net loss could arise at inception if the pricing is out of line with what market participants require. If an insurer identifies an apparently significant gain or loss at inception it would need to check for errors or omissions.

*This column summarises the proposals by GNAIE, four major Japanese life insurers and the CFO Forum. In most cases, these organisations reached a common position. However, for the items marked ** GNAIE's position differs in respect of non-life insurance liabilities.

Industry Proposals ¹	IASB preliminary decisions
<p>5 Liability measurement</p> <p>The liability should be based on the present value of all future cash flows with allowance for inherent risk and uncertainty. **</p> <p>The cash flows should reflect management's best estimate of the future.</p> <p>The best estimate should be equal to the mean estimate (probability-weighted average). **</p>	<p>An insurer should measure insurance liabilities at the amount it would expect to have to pay today if it transferred all its remaining contractual rights and obligations immediately to another entity ('current exit value').</p> <p>Such an approach uses the following inputs:</p> <ul style="list-style-type: none"> • Current unbiased probability-weighted estimates of future cash flows. When market information is available (e.g. for interest rates or equity prices), estimates should be consistent with that data. • Current market discount rates that adjust the estimated future cash flows for the time value of money. • An explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).
<p>6 Discount rate</p> <p>CFO Forum: the appropriate discount rate is the risk-free rate of return specific to the liabilities being measured, adjusted (if appropriate) to reflect absence of identified risk.</p> <p>GNAIE: the discount rate for a life liability should reflect current interest rates and the company's investment strategy.</p> <p>GNAIE: discounting the post-claims non-life liability is inappropriate due to the highly unpredictable payment patterns of most claims.</p>	<p>The discount rates should be consistent with observable market prices for cash flows whose characteristics match those of the insurance liability in terms of timing, currency and liquidity. They should exclude any factors that influence the observed rate but are not relevant to the liability (for example, risks present in the instrument used as a benchmark but not present in the liability).</p> <p>The insurer's investment strategy is not relevant to the measurement of the liability (unless the investment cash flows affect the liability cash flows).</p> <p>Discounting is appropriate for all insurance liabilities.</p>
<p>7 Separate customer intangible asset</p> <p>An intangible asset should be recognised to reflect the initial investment made to acquire the customer relationship.</p> <p>The best proxy for the value of the customer intangible asset at inception should be the initial acquisition cost arising from the contract.</p> <p>Initial acquisition costs represent all costs associated with procuring the insurance contract, including direct and indirect marketing and sales costs, and related overheads.</p>	<p>When an insurer becomes a party to an insurance contract, it should:</p> <ul style="list-style-type: none"> • Recognise, in addition to its (net) contractual rights and contractual obligations, the portion of the customer relationship relating to future payments that the policyholder must make to retain a right to guaranteed insurability. • Measure that portion of the customer relationship and the related liability in the same way, and present them together. <p>An insurer should recognise acquisition costs (i.e. costs to sell, underwrite and initiate a new insurance contract) as an expense when it incurs them.</p>

Industry Proposals	IASB preliminary decisions
<p>8 Review of assumptions</p> <p>Assumptions underlying the measurement of insurance liabilities and intangible assets should be periodically reviewed and updated as appropriate.</p> <p>This review should consider relevant market information and management's best estimate of the future.</p> <p>CFO Forum: Changes in financial assumptions are recognised immediately.</p> <p>For pre-claims liabilities, the implicit profit margin (if any) in addition to the risk margin absorbs adverse changes in non-financial assumptions, and favourable changes in non-financial assumptions are not recognised.</p> <p>GNAIE: Non-life pre-claims liabilities are measured as unearned premium, coupled with a liability adequacy test that uses current assumptions.</p>	<p>The IASB's conclusions on liability measurement require current estimates at measurement date.</p> <p>All changes are recognised immediately, for both financial and non-financial variables.</p> <p>All changes are recognised immediately.</p>
<p>9 Unit of account</p> <p>Measurement should be on a portfolio basis.</p>	<p>Risk margins should:</p> <ul style="list-style-type: none"> • Be determined for a portfolio of insurance contracts that are subject to broadly similar risks and managed together as a single portfolio. • Not reflect benefits, if any, of diversification between portfolios and negative correlation between portfolios.
<p>10 Policyholder behaviour</p> <p>Policyholder behaviour including recurring premiums and lapses should be reflected in the measurement of liabilities. Because policyholder behaviour is taken into account, no deposit floor is appropriate.</p> <p>The cash flows included in the estimate of the insurance liability should:</p> <ul style="list-style-type: none"> • Include only those associated with current insurance contracts and any existing ongoing obligation to service policyholders. • Include the value of guarantees and renewal options that provide rights under which the policyholder can obtain a further contract on favourable terms. • Exclude cash flows from expected renewals that are not included within current insurance contracts. 	<p>The cash flows used in measuring the insurance liability should include future premiums specified in the contract (and additional benefits that result from those premiums) to the extent that any of the following conditions is satisfied:</p> <ul style="list-style-type: none"> • The insurer has an unconditional contractual obligation to stand ready to accept premiums whose present value is less than the present value of the resulting additional benefit payments. • The insurer has an unconditional contractual right to enforce payment of the premiums. This is not a typical case, but it does occur. • The policyholder must pay the premiums to retain a right to guaranteed insurability (a right that permits continued coverage without reconfirmation of the policyholder's risk profile, at a price that is contractually constrained).
<p>11 Options and guarantees</p> <p>Options and guarantees should be included in the measurement of the liability reflecting both their time value and their intrinsic value.</p>	<p>Implied by the current exit value approach.</p>

Industry Proposals	IASB preliminary decisions
<p>12 Unbundling</p> <p>No unbundling of underlying financial and non-financial components of insurance contracts.</p>	<ul style="list-style-type: none"> • The Phase II standard should apply to the whole contract if the components are so interdependent that they could only be measured separately on an arbitrary basis. • If the components are not interdependent, IAS 39 should apply to the deposit element and the Phase II standard should apply to the insurance element. • If the components are interdependent but may be measured separately on a basis that is not arbitrary, IAS 39 would apply to the deposit element. The whole contract will continue to be accounted for under the principles of the Phase II standard with the insurance element measured as the difference between the amount for the whole contract and the deposit element.
<p>13 Own credit risk</p> <p>The credit standing of an insurance contract should not be considered in the valuation of insurance liabilities.</p>	<p>The current exit value of a liability reflects its credit characteristics.</p> <p>An insurer should disclose any material effect of such credit characteristics at inception as well as disclosing the effect of any subsequent changes.</p>
<p>14 Asset and liability consistency</p> <p>Entities should measure assets and liabilities on a consistent basis to reflect the way companies manage risk. **</p> <p>Where the value of the insurance liability is linked, contractually or through other legal or regulatory terms, to the value of associated assets, the value of the insurance liabilities is calculated with reference to the market value of the assets at the valuation date.</p>	<p>The IASB does not expect this project to change existing IFRSs (e.g. IAS 39) for assets held by insurers (except possibly in some cases where the liability cash flows are contractually determined by the assets).</p> <p>In general, under the IASB's tentative conclusions, insurance liabilities and related assets will be measured on a consistent basis if the assets are measured at fair value through profit or loss.</p> <p>Current exit value of these linked liabilities will reflect the fair value of the assets to which they are linked.</p> <p>There may be an accounting mismatch if the linked assets are not carried at fair value through profit or loss (e.g. treasury shares, owner-occupied property, subsidiary held by unit-linked fund). The discussion paper will review possible ways of eliminating this mismatch, but will not express a tentative conclusion.</p>

Industry Proposals	IASB preliminary decisions
<p data-bbox="224 317 250 342">15</p> <p data-bbox="310 317 540 342">Participating contracts</p> <p data-bbox="310 365 834 390">These principles apply equally to participating contracts.</p> <ul data-bbox="407 403 873 579" style="list-style-type: none"><li data-bbox="407 403 873 485">• Liabilities should include the best estimate of future policyholder benefits (dividends, bonuses, etc.)<li data-bbox="407 497 873 579">• The best estimate of future policyholder benefits should be based on the other assumptions used to estimate liabilities. <p data-bbox="310 594 818 646">Amounts that are expected to be paid to policyholders should therefore not be included in equity.</p>	<p data-bbox="904 365 1463 562">The cash flows used in measuring a participating insurance liability should incorporate for each scenario an unbiased estimate of the policyholder dividends payable in that scenario to satisfy a legal or constructive obligation that exists at the reporting date. Such an obligation may often arise when the insurer becomes a party to the participating contract, but that depends on the facts of each case.</p> <p data-bbox="904 577 1471 688">An insurer would need to consider the guidance in IAS 37 to determine whether such an obligation exists. The Board plans to issue a revised version of IAS 37 in 2008, building on the exposure draft of 2005.</p> <p data-bbox="904 703 1471 842">In estimating the policyholder dividends payable in a scenario, an insurer would need to consider various possible sources (to the extent that the insurer has a legal or constructive obligation to pay policyholder dividends from those sources):</p> <ul data-bbox="1002 856 1471 1570" style="list-style-type: none"><li data-bbox="1002 856 1471 1087">• Policyholder surplus that is recognised in the financial statements. If the insurer has a legal or constructive obligation to distribute the policyholder surplus in all scenarios, the insurer would recognise the entire policyholder surplus as a liability. The insurer would also need to consider the effect of any embedded options and guarantees.<li data-bbox="1002 1102 1471 1270">• Amounts that are recognised in the financial statements but will not be included in policyholder surplus until a future period (for example if distributable amount is based on realised gains and excludes gains that are recognised but unrealised).<li data-bbox="1002 1285 1471 1570">• Future premiums that are included in the cash flow scenario (because they pass the guaranteed insurability test). For example, if a scenario includes CU100 of premiums and the insurer estimates that it will pay additional policyholder dividends of CU20 in that scenario because of those premiums, the scenario would include both the premiums and the resulting policyholder dividends.

Appendix 2 Draft guidance on risk margins (Appendix F in discussion paper)

The IASB's proposed measurement approach, current exit value, includes a risk margin. The risk margin is an explicit and unbiased estimate of what market participants would require for bearing the risk of the contract. It is not meant to provide a shock absorber for the unexpected or to enhance the insurer's solvency, but rather to provide information to users of accounts concerning the uncertainty associated with the estimated future cash flows (see Chapter 3b for more details).

Appendix F of the discussion paper provides guidance concerning the criteria to be considered when selecting an approach to the evaluation of risk margins. As risk margins are not typically observable, either at contract inception or in subsequent reporting periods, the IASB recommends that an entity should perform the following:

- Assess which units market participants would use to measure the quantity of risk (e.g. multiple of standard deviation of the estimated probability distribution of future cash flows);
- Determine the number of units of risk present in the liability based on the cash flow scenarios used in estimating the expected present value of cash flows (e.g. what is the standard deviation of the estimated probability distribution); and
- Determine the estimated margin per unit of risk using a combination of sources including market prices and pricing models (e.g. margin per standard deviation).

The estimated margin per unit of risk is multiplied by the estimated number of units to derive the aggregate margin. The change in this aggregation margin is recognised as income or expense. There is a general expectation that risk should reduce over time as the insurer is released from risk. However, it could increase for certain reasons, including unforeseen sources of uncertainty or embedded options that come into the money.

The criteria that should be followed for determining risk margins are set out below:

- The risk margin should be consistent with the margin that would be expected if the insurer transferred all the contractual rights and obligations to another party. In other words, the risk margin should reflect all risks associated with the insurance liability;
- The risk margin would not reflect risks that do not arise from the liability, such as investment risk (except where investment risk affects the amount of payouts to policyholders) or asset-liability mismatch risk;
- The risk margin should be explicit, not implicit;
- Risk margins should be as consistent as possible with observable market prices. The IASB acknowledges that insurance liabilities expose insurers to market variables (e.g. interest rates) and non-market variables (e.g. mortality, frequency and severity of claims). Risk margins should therefore include components related to market variables and non-market variables. Risk margins associated with the market variable component can be based on observed prices, but care should be taken not to double count for the risk margin that may already be included implicitly in the market price. Overall, the total risk margin for the market variable and non-market variable components may not equal the sum of the risk margins individually determined if the risks are interrelated;
- The approach should be implemented at a reasonable cost and in a reasonable time and be auditable by all insurers of all sizes;
- The approach should take account of the tail risk in contracts with skewed payoffs, such as contracts that contain embedded options (e.g. guaranteed minimum interest rates) or cover low-frequency high-severity risks (e.g. earthquake);
- The approach should make it easy to provide information that can be compared to other insurers;

- If more than one approach can be used, it is preferable that the insurer select an approach that builds on models it uses to run its business (e.g. building on economic capital model, an embedded value model or a model developed for solvency);
- The approach should not overlook model risk (the risk that a model is not a good description of the underlying process) or parameter risk (the risk that a model uses estimates of parameters that differ from the true parameter, or that the parameters may change over time). However, this may be difficult to quantify.

The IASB suggests the following approaches (or combinations thereof) to determine risk margins:

- Explicit confidence levels/explicit minimum confidence levels;
- Conditional tail expectations sometimes known as tail value-at-risk (Tail VaR), based on a percentile of expected value of all outcomes;
- Explicit margin within a specified range;
- Cost of capital approach that estimates the cost of holding the capital that is needed to give policyholders comfort that valid claims will be paid and to comply with regulatory capital requirements, if any;
- Capital-asset pricing models or related asset-pricing models; and
- Multiples of one or more specified parameters of the estimated probability distribution (e.g. multiples of standard deviation).

The risk margin is not a new concept. Under existing accounting practices, it may have been part of the risk-adjustment to the discount rate, or implied in the estimated future cash flows of claims incurred or of the future benefits to be paid under life policies. Unlike most existing practice, the risk margin under the current exit value approach must be explicit.

The discussion paper provides guidance on what to consider in developing and determining risk margins, but does not prescribe methods or specific techniques to be used. Further guidance may be required to help insurers provide comparable margins.

Additional supplementary guidance may be found in the International Actuarial Association (IAA) draft report on estimates of cash flows and risk margins, which was commissioned by the IAIS. Although the report is intended for supervisors, it does highlight considerations that could be relevant to determining risk margins under the quartile percentage approach and the cost of capital approach.

Groups such as the CFO Forum recommend that the risk margin for market-variable components could be based on the use of a 'replicating portfolio' (of traded financial instruments to price the expected cash flows) and the risk margins for non-market-variable components be based on a cost of capital approach.

In relation to risk margins for reinsurance assets, there is an implied symmetry between the risk margins of the underlying insurance liability and the portion that is reinsured. Insurers need to consider the basis for which risk margins can be determined for default or dispute risks. The latter may require some thought as to the basis for which this could be quantified in a risk margin included in the measurement of the reinsurance asset.

If the current entry value approach were to be adopted, the risk margins would be calibrated to the premiums less acquisition costs.

Appendix 3 Comparison with IAS 39 (Appendix B in discussion paper)

The accounting treatment of insurance contracts (accounted for under the proposed current exit value model) and the accounting treatment of investment contracts (accounted for under IAS 39 and IAS 18) differs significantly.

The most significant differences are the following:

	Insurance contracts, accounted for under the current exit value model	Investment contracts, accounted for under IAS 39 and IAS 18
Liability measurement	The current exit value model is based on expected values; the liability can fall short of the surrender value.	The liability is subject to a minimum of the surrender value (if measured at fair value through income) or to embedded derivative accounting (if the surrender option is not approximately equal to the carrying amount of the host contract, the option must be separated and fair valued).
Gains on initial measurement	The current exit value model recognises gains on inception (if any gain arises).	Under IAS 39, day one gains for instruments that do not have an observable price cannot be recognised unless the gain is determined using a valuation technique that uses only observable market data.
Non-incremental transaction / origination costs	Under the current exit value model, if the contract is priced to recover acquisition costs from premiums due under the guaranteed insurability principle, the resulting income on day one loss is likely to be similar to its acquisition costs (both incremental and not).	Non-incremental origination costs are likely to give rise to a loss at inception, even if the contract is priced to recover those costs.
Use of current assumptions for subsequent measurement	Current assumptions are used in the measurement of the liability.	If the contract is measured at amortised cost, some assumptions are locked in at inception.

Consistent treatment could be achieved either by unbundling insurance contracts into their investment and insurance components, or by eliminating the differences in the accounting treatment of investment contracts and insurance contracts.

The IASB is seeking feedback on whether it should consider eliminating the differences in the accounting treatment of investment contracts and insurance contracts (particularly in the life insurance sector).

Appendix 4 Issues not covered in the discussion paper (Appendix D in discussion paper)

The discussion paper excludes a number of issues that will not be covered or will be discussed at a later stage:

- Items that are unlikely to be changed from current IFRS include the definition of an insurance contract, the basis for disclosure, derecognition of insurance assets and the non-recognition of catastrophe provisions and equalisation reserves as liabilities;
- It is beyond the scope of the insurance project to change accounting for deferred tax (e.g. use of discounting);
- Policyholder accounting.

Appendix 5 Contacts

If you would like to discuss any of the issues in this paper, please speak to your usual contact at PricewaterhouseCoopers, or one of the following:

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