

IFRS Briefing Sheet

Discussion Paper *Preliminary Views on Insurance Contracts*

May 2007, **Issue 68**

This IFRS Briefing Sheet summarises the International Accounting Standards Board's (IASB) Discussion Paper (DP) *Preliminary Views on Insurance Contracts* which was published on 3 May 2007.

insurance contracts. This DP addresses insurance liabilities (an insurer's obligations under an insurance contract) and insurance assets (an insurer's rights under an insurance contract). The IASB expects to publish an exposure draft for phase II of the project by late 2008 and a final standard by late 2009.

Background

This DP was issued by the IASB as part of phase II of its project on accounting for insurance contracts by both insurers and policyholders, which was started in 1997. This project was initiated mainly because:

- there was no specific IFRS on insurance contracts
- insurance contracts are excluded from the scope of other relevant IFRSs that might otherwise apply
- current accounting practice for insurance contracts is diverse, and often differs from practices in other sectors.

The Board completed phase I of this project in March 2004 with the issue of IFRS 4 *Insurance Contracts*. IFRS 4 focuses on types of contracts rather than types of entities. Therefore it applies to both entities regulated as insurance entities and all other entities. IFRS 4 includes a definition of an insurance contract, limited recognition and measurement requirements, and comprehensive disclosures about

The U.S. Financial Accounting Standards Board (FASB) plans to issue an Invitation to Comment containing this DP. Depending on the responses it receives, the FASB will decide whether to add an insurance contracts project to the joint project agenda with the IASB.

Summary of Preliminary Views Scope and Definition

This DP applies to insurance contracts issued by insurers and reinsurance contracts held by insurers. This DP does not address the treatment of any other assets or liabilities held by insurers. Although the Board plans to address policyholder accounting in the insurance contracts project, this DP does not address this issue.

IFRS 4 defines an insurance contract as a "contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified future uncertain event (the insured event) adversely affects the policyholder". The Board will consider overall comments

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on this DP to determine if this definition still is appropriate.

Recognition and Derecognition

It is the Board's preliminary view that an insurer should recognise rights and obligations resulting from insurance contracts when it becomes a party to the contract.

In addition, IFRS 4 requires an insurer to derecognise an insurance liability (or a part thereof) when it is extinguished, i.e., the contractual obligation is discharged, cancelled or expires. The Board does not propose to change that requirement.

This DP does not address the derecognition of insurance assets.

Measurement – Core Issues

The Board's objective is to choose an insurance contract measurement model that provides useful information about the amount, timing and uncertainty of the future cash flows of the contract. It is the Board's preliminary view that an insurer should measure all of its insurance liabilities at "current exit value" or, essentially, "the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity".

The Board's preliminary view is that current exit values should be measured using the following "building blocks":

1. explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows
2. current market discount rates that adjust the estimated future cash flows for the time value of money
3. explicit and unbiased estimates of the margin that market participants require for bearing risk (a risk margin), and for providing other services if any (a service margin).

In respect of the first building block, this DP notes that insurers may already use estimates of future cash flows when testing the adequacy of liabilities or in pricing decisions. However, this DP makes the observation that a current estimate approach may result in more emphasis being placed on the estimates of cash flows than most existing approaches because any changes in estimated cash flows under a current estimate approach affect profit or loss immediately.

In addition, it is the Board's preliminary view that the estimate of cash flows should represent the *expected present value* of the cash flows generated by the insurance contract. As a result, the estimate should capture information about the full range of possible outcomes and their probabilities. Also, to the extent possible, inputs used to develop estimated cash flows should be consistent with observed market prices. As an example, when an estimate is based on observable market variables such as interest rates, then the variables should be used as an input without adjustment.

In respect of the second building block, it is the Board's preliminary view that discounting should be used for all insurance liabilities. The discount rate used to adjust estimated future cash flows for the time value of money 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. Therefore the discount rate should exclude any factors that influence the observed rate but are not relevant to the liability.

In respect of the last building block, the Board proposes that risk and service margins be included in the measurement of the insurance liability. The Board has proposed the method to calibrate the explicit and unbiased risk margin at *inception* of the contract:

- | use the observed price with the policyholder, resulting in no net gain at inception
- | the observed price should not override an unbiased estimate of the margin that another party would require if it took over the insurer's rights and obligations, potentially resulting in a net gain at inception.

This DP does not prescribe the specific methods for determining the risk and service margins, but does provide guidance on the characteristics that the margins should possess.

Insurance Contracts Acquired in Business Combinations and Portfolio Transfers

IFRS 3 *Business Combinations* requires an entity to measure assets acquired and liabilities assumed in a business combination at fair value. IFRS 4 does not exclude insurance assets and liabilities from that fair value measurement requirement. In November 2006 the IASB published a discussion paper seeking views on the definition of fair value as defined in the U.S. Generally Accepted Accounting Principles standard, SFAS 157 *Fair Value Measurements*. While the insurance contracts DP does not identify a significant difference between current exit value and fair value, the IASB will not be in a position to reach a final conclusion on whether there is a difference until it has completed its projects on both insurance contracts and fair value measurements. If a significant difference is found to exist then the expanded presentation that splits fair value into two components – liability and intangible asset, as allowed by IFRS 4, may be retained. If no significant difference is found, then such expanded presentation will not be needed.

When an entity acquires a portfolio of insurance contracts, in the Board's preliminary view, any difference between the current exit value and

the consideration received should be recognised in profit or loss.

Portfolio Basis of Measurement

This DP addresses whether the measurement of a portfolio of insurance contracts would differ if performed on a portfolio basis versus a contract-by-contract basis. This DP states that in principle the expected cash flows from a portfolio of insurance contracts should equal the sum of the expected cash flows of the individual contracts. Therefore the Board's preliminary view is that the unit of measure (contract-by-contract or portfolio basis) should not impact the expected present value of cash flows calculations.

This DP notes that risk margins should be determined for a portfolio of insurance contracts that are subject to similar risks and that are managed as a single portfolio. This DP also highlights that risk margins should not reflect the benefits of diversification.

Acquisition Costs

Insurers often incur significant acquisition costs (costs to sell, underwrite and initiate new insurance contracts). This DP makes the observation that many current accounting models defer acquisition costs. In the Board's preliminary view, acquisition costs should be recognised as an expense as they are incurred.

Reinsurance

The Board's preliminary view is that reinsurance liabilities should not be treated any differently from direct insurance liabilities, in that they also should be measured at current exit value.

Unbundling

As most policyholders pay premiums in advance, the underlying contracts

contain an explicit or implicit deposit component that would, if it were a stand-alone financial instrument, be within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. In the Board's preliminary view if an insurance contract contains both an insurance component and a deposit component, then generally the guidance in this DP should apply to the insurance component and IAS 39 should apply to the deposit component. If, however, the deposit component and the insurance contract are so interdependent that the components can be measured only on an arbitrary basis, then the guidance in this DP should be applied to the contract as a whole.

Future Premiums and Policyholder Behaviour

It is the Board's preliminary view that when an insurer has rights to future premiums that a policyholder must make to retain a right to guaranteed insurability (i.e., continued coverage for a policyholder without reconfirmation of their risk profile), the future premiums should be recognised as an asset. The asset is to be viewed as being part of a customer relationship rather than a contractual right, but should be presented as part of the related insurance liability and measured at current exit value.

Policyholder Participation

Participating insurance contracts entitle policyholders to benefit from the favourable performance of a group of contracts or related assets (i.e., if a contract performs favourably then the insurer will refund part of the premium to the participating policyholders). Policyholder participation rights create a liability for the insurer when it has an unconditional legal or constructive obligation to transfer benefits to

the policyholders. This DP refers to the guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to determine whether the insurer has a liability.

Universal Life Contracts

Universal life contracts allow policyholders to vary the amount of premiums and the amount of life insurance coverage, within specified limits. It is the Board's preliminary view that the estimated cash flows used for measuring a universal life contract insurance liability should incorporate the anticipated rates (or essentially the interest credits) that the insurer estimates would apply in order to meet the insurer's legal or constructive obligation, rather than the contractually required minimum.

Unit-linked Contracts

In unit-linked insurance contracts, some or all policyholder benefits are contractually determined by the price of the units in an investment fund (i.e., a designated pool of assets). Accounting mismatches can arise when the pool of assets (known as "separate assets") from which the benefits of the unit-linked contract are derived is not recognised at fair value through profit or loss. This DP states that the IASB would prefer to eliminate these accounting mismatches; however, has not yet formed any preliminary views on how this should be achieved.

Response to the IASB

The IASB has invited comments on this DP by 16 November 2007.

If you would like further information on any of the matters discussed in this issue of *IFRS Briefing Sheet*, please talk to your usual local KPMG contact or call any of KPMG firms' offices.

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Publication name: *IFRS Briefing Sheet*

Publication number: Issue 68

Publication date: May 2007