

**Draft Implementation Guidance**  
**ED 5 INSURANCE CONTRACTS**

*Comments to be received by 31 October 2003*

This draft Implementation Guidance accompanies the proposed International Financial Reporting Standard (IFRS) set out in ED 5 *Insurance Contracts* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **31 October 2003**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org.uk** or addressed to:

**Peter Clark**  
**Senior Project Manager**  
**International Accounting Standards Board**  
**30 Cannon Street, London EC4M 6XH, United Kingdom**

**Fax: +44 (0)20 7246 6411**

Copyright © 2003 International Accounting Standards Committee Foundation (IASCF)

ISBN for this part: 1-904230-30-X

ISBN for complete publication (three parts): 1-904230-27-X

All rights reserved. Copies of the draft IFRS and its accompanying documents may be made for the purpose of preparing comments to be submitted to the IASB, provided such copies are for personal or intra-organisational use only and are not sold or disseminated and provided each copy acknowledges the International Accounting Standards Committee Foundation's copyright and sets out the IASB's address in full. Otherwise, no part of this publication may be translated, reprinted or reproduced or utilised in any form either in whole or in part or by any electronic, mechanical or other means, now known or hereafter invented, including photocopying and recording, or in any information storage and retrieval system, without permission in writing from the International Accounting Standards Committee Foundation.

The IASB logo/"Hexagon Device", "IAS", "IASB", "IASCF", "IASC", "IFRIC", "IFRS", "International Accounting Standards" and "International Financial Reporting Standards" are Trade Marks of the International Accounting Standards Committee Foundation and may not be used without the prior written approval of the IASCF.

**Additional copies of this publication may be obtained from:**  
**IASCF Publications Department,**  
**1st Floor, 30 Cannon Street, London EC4M 6XH, United Kingdom.**  
**Tel: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749**  
**Email: publications@iasb.org.uk Web: www.iasb.org.uk**

## Contents

### ED 5 Insurance Contracts

#### [Draft] Implementation Guidance

	<i>paragraphs</i>
<b>INTRODUCTION</b>	<b>IG1</b>
<b>DEFINITION OF INSURANCE CONTRACT</b>	<b>IG2</b>
<b>EMBEDDED DERIVATIVES</b>	<b>IG3-4</b>
<b>UNBUNDLING A DEPOSIT COMPONENT</b>	<b>IG5-6</b>
<b>DISCLOSURE</b>	<b>IG7-61</b>
<b>Explanation of reported amounts</b>	<b>IG7-30</b>
Accounting policies	IG7-8
Material assets, liabilities, income and expense	IG9-18
Significant assumptions and other sources of measurement uncertainty	IG19-23
Changes in assumptions	IG24-26
Changes in insurance liabilities and related items	IG27-30
<b>Amount, timing and uncertainty of future cash flows</b>	<b>IG31-59</b>
Risk management objectives and policies for mitigating insurance risk	IG37
Terms and conditions of insurance contracts	IG38-39
Insurance risk	IG40
Sensitivity analysis	IG41-43
Concentrations of insurance risk	IG44-47
Claims development	IG48-49
Interest risk and credit risk	IG50-53
Material exposures to interest risk or market risk under embedded derivatives	IG54-58
Key performance indicators	IG59
<b>Fair value of insurance liabilities and insurance assets</b>	<b>IG60-61</b>

**LIST OF EXAMPLES**

	<i>after paragraphs</i>
<b>1 Application of the definition of an insurance contract</b>	<b>IG2</b>
<b>2 Embedded derivatives</b>	<b>IG4</b>
<b>3 Unbundling a deposit component of a reinsurance contract</b>	<b>IG6</b>
<b>4 Disclosure of claims development</b>	<b>IG49</b>

## **[Draft] Guidance on implementing [draft] IFRS X Insurance Contracts**

*This guidance accompanies, but is not part of, the [draft] IFRS.*

### **INTRODUCTION**

- IG1 This implementation guidance:
- (a) illustrates which contracts and embedded derivatives are subject to the [draft] IFRS (see paragraphs IG2-IG4).
  - (b) includes an example of an insurance contract containing a deposit component that needs to be unbundled (paragraphs IG5 and IG6).
  - (c) discusses how an insurer might satisfy the disclosure requirements in the [draft] IFRS (paragraphs IG7-IG61).

### **DEFINITION OF INSURANCE CONTRACT**

- IG2 IG Example 1 illustrates the application of the definition of an insurance contract. The example does not illustrate all possible circumstances.

<b>IG Example 1: Application of the definition of an insurance contract</b>	
<i>Contract type</i>	<i>Treatment in phase I</i>
1.1 Insurance contract (see definition in Appendix A of the [draft] IFRS and guidance in Appendix B).	Subject to the [draft] IFRS, unless covered by scope exclusions in paragraph 4 of the [draft] IFRS. Some embedded derivatives and deposit components must be separated (see below).
1.2 Death benefit that could exceed amounts payable on surrender or maturity.	Insurance contract (unless contingent amount is insignificant in all plausible scenarios). Insurer could suffer a significant loss on an individual contract if the policyholder dies early.
1.3 Life-contingent annuity.	Insurance contract (unless contingent amount is insignificant in all plausible scenarios). Insurer could suffer a significant loss on an individual contract if the annuitant survives longer than expected.
<i>continued...</i>	

<b>IG Example 1: Application of the definition of an insurance contract</b>	
<i>Contract type</i>	<i>Treatment in phase I</i>
1.4 Pure endowment. Policyholder receives a payment on survival to a specified date, but beneficiaries receive nothing if the policyholder dies before then.	Not an insurance contract unless there is a significant probability that the holder will not survive until the specified date. The contract provides a fixed payment with a small possibility of a significant gain for the issuer if the policyholder dies.
1.5 Deferred annuity: policyholder will receive, or can elect to receive, a life-contingent annuity at rates guaranteed at inception.	Insurance contract. Insurer is exposed to significant mortality risk from inception, because it could suffer a significant loss on an individual contract if the annuitant elects to take the life-contingent annuity and survives longer than expected (unless the contingent amount is insignificant in all plausible scenarios).
1.6 Deferred annuity: policyholder will receive, or can elect to receive, a life-contingent annuity at rates prevailing when the annuity begins.	Not an insurance contract at inception, if the insurer can reprice the mortality risk without constraints. Subject to IAS 39 <i>Financial Instruments: Recognition and Measurement</i> , unless the contract contains a discretionary participation feature.  Will become an insurance contract when the annuity rate is fixed (unless the contingent amount is insignificant in all plausible scenarios).
1.7 Investment contract* that does not contain a discretionary participation feature.	Subject to IAS 39.
1.8 Investment contract containing a discretionary participation feature.	Paragraph 25 of the [draft] IFRS sets out requirements for these contracts, which [would be] excluded from the scope of IAS 39.
1.9 Investment contract in which payments are contractually linked (with no discretion) to returns on a specified pool of assets held by the issuer.	Subject to IAS 39. The link to the investment return creates an embedded derivative that typically requires separation.
<i>continued...</i>	

\* The term 'investment contract' is an informal term used for ease of discussion. It refers to a financial instrument that does not meet the definition of an insurance contract.

<b>IG Example 1: Application of the definition of an insurance contract</b>	
<i>Contract type</i>	<i>Treatment in phase I</i>
1.10 Contract that requires the issuer to make payments to a creditor if a specified debtor fails to make payment when due. The contract may have various legal forms (eg insurance contract, financial guarantee or letter of credit).	Insurance contract. Subject to the [draft] IFRS, unless the contract arises from the derecognition of assets or liabilities.  If the issuer's existing accounting policies do not require it to recognise a liability at inception, the loss recognition test in paragraphs 11-13 of the [draft] IFRS applies.  The legal form of the contract does not affect its recognition and measurement.
1.11 A financial guarantee that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due.	Not an insurance contract. Subject to IAS 39 (see IAS 39 <i>Implementation Guidance</i> IGC 1-2, IGC 1-5-a and IGC 1-5-b).
1.12 A financial guarantee contract that provides for payments to be made in response to changes in a specified interest rate, security price, commodity price, credit rating or credit index, foreign exchange rate, index of prices or rates, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.	A derivative. Subject to IAS 39.
1.13 Guarantee fund established by contract. The contract requires all participants to pay contributions to the fund so that it can meet obligations incurred by participants (and, perhaps, others). Participants would typically be from a single industry, eg insurance, banking or travel.	The contract that establishes the guarantee fund is an insurance contract (see 1.10 above).
1.14 Guarantee fund established by law.	The commitment of participants to contribute to the fund is not established by a contract, so there is no insurance contract. Subject to IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i> .
<i>continued...</i>	

ED 5 INSURANCE CONTRACTS

<b>IG Example 1: Application of the definition of an insurance contract</b>	
<i>Contract type</i>	<i>Treatment in phase I</i>
1.15 Residual value insurance or residual value guarantee. Guarantee by one party of the fair value at a future date of a non-financial asset held by a beneficiary of the insurance or guarantee.	<p>Insurance contract subject to the [draft] IFRS. The risk of changes in the fair value of the non-financial asset is not a financial risk because the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific asset held (a non-financial variable).</p> <p>However, if the contract compensates the beneficiary only for changes in market prices and not for changes in the condition of the beneficiary's asset, the contract is a derivative and subject to IAS 39.</p> <p>Residual value guarantees given by a lessee under a finance lease are within the scope of IAS 17 <i>Leases</i>.</p>
1.16 Product warranties issued directly by a manufacturer, dealer or retailer.	Insurance contracts, but excluded from scope (see IAS 18 <i>Revenue</i> and IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i> ).
1.17 Product warranties issued by a third party.	Insurance contracts, no scope exclusion. Same treatment as other insurance contracts.
1.18 Group insurance contract that gives the insurer an enforceable and uncancellable contractual right to recover claims paid out of future premiums.	<p>Insurance contract, if insurance risk is significant.</p> <p>If insurance risk is insignificant, financial instrument subject to IAS 39. Servicing fees are subject to IAS 18 <i>Revenue</i> (recognise as services are provided, subject to various conditions, see paragraph 20 of IAS 18).</p>
1.19 Catastrophe bond: bond in which principal and/or interest payments are reduced if a specified triggering event occurs and the triggering event does not include a condition that the issuer of the bond suffered a loss.	<p>Financial instrument with embedded derivative. [The current scope of IAS 39 excludes weather derivatives, but the [draft] IFRS would remove this scope exclusion.] Both the holder and the issuer measure the embedded derivative at fair value.</p>
<i>continued...</i>	



<b>IG Example 1: Application of the definition of an insurance contract</b>	
<i>Contract type</i>	<i>Treatment in phase I</i>
1.20 Catastrophe bond: bond in which principal and/or interest payments are reduced if a specified triggering event occurs and the triggering event includes a condition that the issuer of the bond suffered a loss.	<p>The contract is an insurance contract, and contains an insurance contract component (with the issuer as policyholder and the holder as the insurer) and a deposit component.</p> <p>(a) Paragraph 7 of the [draft] IFRS requires the holder to unbundle the deposit component and apply IAS 39 to it.</p> <p>(b) The issuer accounts for the insurance component as reinsurance if it uses the bond for that purpose. If the issuer does not use the insurance component as reinsurance, it is not within the scope of the [draft] IFRS, which does not address accounting by policyholders for direct insurance contracts.</p> <p>(c) Under paragraph 9 of the [draft] IFRS, the holder could continue its existing accounting for the insurance component, unless that involves the practices prohibited by paragraph 10.</p>
1.21 A contract issued by an insurer to a defined benefit pension plan covering the employees of the insurer, or of another entity consolidated within the same financial statements as the insurer.	<p>The contract will generally be eliminated from the financial statements, which will include:</p> <p>(a) the full amount of the pension obligation under IAS 19 <i>Employee Benefits</i>, with no deduction for the plan's rights under the contract.</p> <p>(b) no liability to policyholders under the contract.</p> <p>(c) the assets backing the contract.</p>

## EMBEDDED DERIVATIVES

IG3 IAS 39 *Financial Instruments: Recognition and Measurement* requires an entity to separate embedded derivatives that meet specified conditions from the host instrument that contains them, measure the embedded derivatives at fair value and recognise changes in their fair value in profit or loss. However, an insurer need not separate an embedded derivative that itself meets the definition of an insurance contract (paragraph 5 of the [draft] IFRS). Nevertheless, separation and fair value measurement of an embedded derivative are not prohibited if the insurer's existing accounting

policies require such separation, or if an insurer changes its accounting policies and that change meets the criteria in paragraph 14 of the [draft] IFRS.

- IG4 IG Example 2 illustrates the treatment of embedded derivatives contained in insurance contracts and investment contracts. The term 'investment contract' is an informal term used for ease of discussion. It refers to a financial instrument that does not expose the issuer to significant insurance risk and so does not meet the definition of an insurance contract. The example does not illustrate all possible circumstances. Throughout the example, the phrase "fair value measurement is required" indicates that the issuer of the contract is required:
- (a) to measure the embedded derivative at fair value and include changes in its fair value in profit or loss.
  - (b) to separate the embedded derivative from the host contract, unless it measures the entire contract at fair value and includes changes in that fair value in profit or loss.

<b>IG Example 2: Embedded derivatives</b>		
<i>Type of embedded derivative</i>	<i>Treatment if embedded in a host insurance contract</i>	<i>Treatment if embedded in a host investment contract</i>
2.1 Death benefit linked to equity prices or equity index, payable only on death or annuitisation and not on surrender or maturity.	The equity-index feature is an insurance contract, because the policyholder benefits from it only when the insured event occurs. Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.2 Death benefit that is the greater of: (a) unit value of an investment fund (equal to the amount payable on surrender or maturity); and (b) guaranteed minimum.	Excess of guaranteed minimum over unit value is a death benefit (similar to the payout on a dual trigger contract, see 2.18 below). This meets the definition of an insurance contract and fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.3 Option to take a life-contingent annuity at guaranteed rate (combined guarantee of interest rates and mortality charges).	The embedded option is an insurance contract. Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
<i>continued...</i>		

<b>IG Example 2: Embedded derivatives</b>		
<i>Type of embedded derivative</i>	<i>Treatment if embedded in a host insurance contract</i>	<i>Treatment if embedded in a host investment contract</i>
2.4 Embedded guarantee of minimum interest rates in determining surrender or maturity values that is out of the money (or at the money) on issue, and not leveraged.	Fair value measurement is not required (but not prohibited). The guaranteed minimum is an embedded deposit component. However, an insurer is not required to unbundle contracts if the insurer's existing accounting policies mean that it recognises all liabilities to pay benefits to policyholders (paragraph 8 of the [draft] IFRS). This may be the case for many traditional life insurance contracts with surrender values.	Fair value measurement is not permitted (paragraph A7(b) of Appendix A of [draft] IAS 39).
2.5 Embedded guarantee of minimum interest rates in determining surrender or maturity values: in the money on issue, or leveraged.	The embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent). Fair value measurement is required (paragraph A4(b) of [draft] IAS 39).	Fair value measurement is required (paragraph A4(b) of [draft] IAS 39).
<i>continued...</i>		

<b>IG Example 2: Embedded derivatives</b>		
<i>Type of embedded derivative</i>	<i>Treatment if embedded in a host insurance contract</i>	<i>Treatment if embedded in a host investment contract</i>
2.6 Embedded guarantee of minimum rates of annuity payments if the annuity payments are contractually linked to investment returns or asset prices (GMIB or guaranteed minimum income benefit):		
(a) guarantee relates only to payments that are life-contingent.	The embedded guarantee is an insurance contract and fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
(b) guarantee relates only to payments that are not life-contingent.	The embedded derivative is not an insurance contract. Fair value measurement is required (unless the guarantee is an unleveraged interest floor that is at or out of the money at inception).	Fair value measurement is required (unless the guarantee is an unleveraged interest floor that is at or out of the money at inception).
(c) policyholder can elect to receive life-contingent payments or payments that are not life-contingent, and the guarantee relates to both.	The embedded option to receive life-contingent payments is an insurance contract. Fair value measurement is not required (but not prohibited). The embedded option to receive payments that are not life-contingent is not an insurance contract. Fair value measurement is generally required. Because this option and the life-contingent option are alternatives, their fair values are interdependent. If the insurer cannot measure reliably the fair value of the embedded non-insurance option, it measures the whole contract at fair value (paragraph 26 of [draft] IAS 39).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
<i>continued...</i>		

<b>IG Example 2: Embedded derivatives</b>		
<i>Type of embedded derivative</i>	<i>Treatment if embedded in a host insurance contract</i>	<i>Treatment if embedded in a host investment contract</i>
2.7 Embedded guarantee of minimum equity returns on surrender or maturity.	The embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent) and is not closely related to the host insurance contract. Fair value measurement is required.	Fair value measurement is required.
2.8 Equity-linked return available on surrender or maturity.	The embedded derivative is not an insurance contract (unless the equity-linked return is life-contingent) and is not closely related to the host insurance contract. Fair value measurement is required.	Fair value measurement is required.
2.9 Embedded guarantee of minimum equity returns that is available only if the policyholder elects to take a life-contingent annuity.	The embedded guarantee is an insurance contract, as the policyholder can benefit from the guarantee only by taking the annuity option (whether annuity rates are set at inception or at the date of annuitisation). Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
2.10 Embedded guarantee of minimum equity returns available to the policyholder as either (a) a cash payment, (b) a period-certain annuity or (c) a life-contingent annuity, at annuity rates prevailing at the <b>date of annuitisation</b> .	The option to take the life-contingent annuity does not create insurance risk until the policyholder opts to take the annuity. Therefore, the embedded guarantee is not an insurance contract and is not closely related to the host investment contract. Fair value measurement is required.	Fair value measurement is required.
<i>continued...</i>		

<b>IG Example 2: Embedded derivatives</b>		
<i>Type of embedded derivative</i>	<i>Treatment if embedded in a host insurance contract</i>	<i>Treatment if embedded in a host investment contract</i>
2.11 Embedded guarantee of minimum equity returns available to the policyholder as either (a) a cash payment (b) a period-certain annuity or (c) a life-contingent annuity, at annuity rates set at <b>inception</b> .	The whole contract is an insurance contract from inception. The option to take the life-contingent annuity is an embedded insurance contract, so fair value measurement is not required (but not prohibited).  The option to take the cash payment or the period-certain annuity is an embedded derivative and is not an insurance contract, so it must be separated. Because this option and the life-contingent option are alternatives, their fair values are interdependent. If the insurer cannot measure reliably the fair value of the embedded non-insurance option, it measures the whole contract at fair value.	Not applicable.
2.12 Policyholder option to surrender a contract for a cash surrender value specified in a schedule (ie not indexed and not accumulating interest).	Fair value measurement is not required (but not prohibited: paragraph 6 of the [draft] IFRS).  The [draft] IFRS does not require an insurer to unbundle the surrender value in a traditional life insurance contract (paragraph 8).	The surrender option is closely related to the host contract if the surrender value is approximately equal to the carrying amount at each exercise date (paragraph A4(g) of [draft] IAS 39). Otherwise, the surrender option is measured at fair value.
2.13 Policyholder option to surrender a contract for account value based on a principal amount and a fixed or variable interest rate (or based on the fair value of a pool of interest-bearing securities), possibly after deducting a surrender charge.	Same as for a cash surrender value (2.12).	Same as for a cash surrender value (2.12).
<i>continued...</i>		

<b>IG Example 2: Embedded derivatives</b>		
<i>Type of embedded derivative</i>	<i>Treatment if embedded in a host insurance contract</i>	<i>Treatment if embedded in a host investment contract</i>
2.14 Policyholder option to surrender a contract for a surrender value based on an equity or commodity price or index.	Fair value measurement is required (paragraph 5 of the [draft] IFRS).	Fair value measurement is required (paragraph A4(d) and (e) of [draft] IAS 39).
2.15 Policyholder option to surrender a contract for account value based on the fair value of a pool of equity investments, possibly after deducting a surrender charge.	Same as for a surrender value based on an equity price or index (2.14).	Same as for a surrender value based on an equity price or index (2.14).
2.16 Persistency bonus paid at maturity in cash (or as a period-certain annuity).	The embedded derivative (option to receive the persistency bonus) is not an insurance contract (unless the persistency bonus is life-contingent). Insurance risk does not include lapse or persistency risk (paragraph B15 of the [draft] IFRS). Fair value measurement is not required (but not prohibited).	An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension (paragraph A4(c) of [draft] IAS 39). If the option or provision is not closely related to the host instrument, fair value measurement is required.
2.17 Persistency bonus paid at maturity in the form of an enhanced life-contingent annuity.	The embedded derivative is an insurance contract. Fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the life-contingent payments are insignificant).
<i>continued...</i>		

<b>IG Example 2: Embedded derivatives</b>		
<i>Type of embedded derivative</i>	<i>Treatment if embedded in a host insurance contract</i>	<i>Treatment if embedded in a host investment contract</i>
2.18 Dual trigger contract, eg payment that is contingent on a breakdown in power supply that adversely affects the holder (first trigger) and a specified level of electricity prices (second trigger).	The embedded derivative is an insurance contract.  A contract that qualifies as an insurance contract, whether at inception or later, remains an insurance contract until all rights and obligations are extinguished or expire (paragraph B25 of the [draft] IFRS). Therefore, although the remaining exposure is similar to a financial derivative after the insured event has occurred, the embedded derivative is still an insurance contract and fair value measurement is not required (but not prohibited).	Not applicable. The entire contract is an insurance contract (unless the contingent payments are insignificant).

## UNBUNDLING A DEPOSIT COMPONENT

- IG5 Paragraph 7 of the IFRS requires an insurer to unbundle deposit components of some insurance contracts. IG Example 3 illustrates this requirement.
- IG6 The unbundling requirement is intended to capture examples of this kind in which a payment by one party leads to automatic repayments by the other party in a future period. Although arrangements of this kind are more common in reinsurance, the same principle applies in direct insurance. However, paragraph 8 of the [draft] IFRS confirms that the unbundling requirement is not intended to capture traditional surrender features in life insurance contracts.



**IG Example 3: Unbundling a deposit component of a reinsurance contract****Background**

A reinsurance contract has the following features:

- (a) The cedant pays premiums of 10 every year for five years.
- (b) An experience account is established, equal to 90 per cent of cumulative premiums (including the additional premiums discussed in (c) below) less 90 per cent of cumulative claims.
- (c) If the balance in the experience account is negative (ie cumulative claims exceed cumulative premiums), the cedant pays an additional premium equal to the experience account balance divided by the number of years left to run on the contract.
- (d) At the end of the contract, if the experience account balance is positive (ie cumulative premiums exceed cumulative claims), it is refunded to the cedant; if the balance is negative, the cedant pays the balance to the reinsurer as an additional premium.

**Application of requirements: case 1 – no claims**

If there are no claims, the cedant will receive 45 back in year 5 (90 per cent of the cumulative premiums of 50). In substance, the cedant has made a loan, which the reinsurer will repay in one instalment of 45 in year 5. Each payment by the cedant has two components: a loan advance and a payment for reinsurance cover. Assume that an appropriate discount rate is 10 per cent and that the reinsurance cover is equal in each year, so that the payment for insurance cover is the same in every year. Each payment by the cedant is then made up of a loan advance of 6.7 and an insurance premium of 3.3. The movements in the loan are shown below.

<i>Year</i>	<i>Opening balance</i>	<i>Interest at 10%</i>	<i>Advance (repayment)</i>	<i>Closing balance</i>
0	0.00	0.00	6.70	6.70
1	6.70	0.67	6.70	14.07
2	14.07	1.41	6.70	22.18
3	22.18	2.22	6.70	31.09
4	31.09	3.11	6.70	40.90
5	40.90	4.10	(45.00)	0.00
Total		<u>11.50</u>	<u>(11.50)</u>	

*continued...*

**IG Example 3: Unbundling a deposit component of a reinsurance contract****Application of requirements: case 2—claim of 150 in year 1**

Consider now what happens if the reinsurer pays a claim of 150 in year 1. The changes in the experience account, and resulting additional premiums, are as follows.

Year	Premium	Additional premium	Total premium	Cumulative premium	Claims	Cumulative claims	Cumulative premiums less claims	Experience account
0	10	0	10	10	0	0	10	9
1	10	0	10	20	(150)	(150)	(130)	(117)
2	10	39	49	69	0	(150)	(81)	(73)
3	10	36	46	115	0	(150)	(35)	(31)
4	10	31	41	156	0	(150)	6	6
		<u>106</u>	<u>156</u>		<u>(150)</u>			

**Incremental cash flows because of the claim in year 1**

The claim in year 1 leads to the following incremental cash flows, compared with case 1:

Year	Additional premium	Claims	Refund in case 2	Refund in case 1	Net incremental cash flow	Present value at 10%
0	0	0			0	0
1	0	(150)			(150)	(150)
2	39	0			39	35
3	36	0			36	30
4	31	0			31	23
5	0	0	(6)	(45)	39	27
Total	<u>106</u>	<u>(150)</u>	<u>(6)</u>	<u>(45)</u>	<u>(5)</u>	<u>(35)</u>

*continued...*

**IG Example 3: Unbundling a deposit component of a reinsurance contract**

The incremental cash flows have a present value, in year 1, of 35. Under paragraph 7 of the [draft] IFRS, the cedant unbundles this deposit component. If this were not done, the cedant might recognise the 150 received in year 1 as income, and the incremental payments in years 2-5 as expenses. However, in substance, the reinsurer has paid a claim of 35 and has made a loan of 115 (150 less 35) that will be repaid in instalments, as shown below.

**Loan from the reinsurer to the cedant**

<i>Year</i>	<i>Opening balance</i>	<i>Interest at 10%</i>	<i>Payment</i>	<i>Closing balance</i>
1	0	0	115	115
2	115	12	(39)	88
3	88	9	(36)	61
4	61	6	(31)	36
5	36	3	(39)	0
Total		30	(30)	

**DISCLOSURE****Explanation of reported amounts  
(paragraphs 26 and 27 of the [draft] IFRS)****Accounting policies**

IG7 IAS 1 *Presentation of Financial Statements* requires disclosure of accounting policies and paragraph 27(a) of the [draft] IFRS highlights this requirement. In developing disclosures about accounting policies for insurance contracts, insurers may need to address the treatment of, for example:

- (a) premiums (including the treatment of unearned premiums, renewals and lapses, premiums collected by agents and brokers but not yet passed on and premium taxes or other levies on premiums).
- (b) fees or other charges made to policyholders.

- (c) acquisition costs (including a description of the nature of these costs).
- (d) claims incurred (including claims incurred but not reported), claims handling costs (including a description of the nature of these costs) and premium deficiencies. An insurer discloses whether these liabilities are discounted and, if they are discounted, explains the methodology used.
- (e) risk and uncertainty including, when applicable, the objective of the methodology used to adjust insurance liabilities for risk and uncertainty (for example, in terms of a confidence level) the nature of the models used, and the source of parameters used in the models.
- (f) embedded options and guarantees.
- (g) discretionary performance features and investment-linking features.
- (h) salvage, subrogation or other expected recoveries from third parties.
- (i) reinsurance held.
- (j) underwriting pools, coinsurance and guarantee fund arrangements.
- (k) as proposed in paragraph 108 of the May 2002 Exposure Draft of improvements to IAS 1, the judgements made by management in applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements.

IG8 An insurer discloses the methodology used to determine the fair values disclosed to comply with paragraph 30 of the [draft] IFRS. If the financial statements disclose supplementary information, for example embedded value information, that is not prepared on the basis used for other measurements in the financial statements, an insurer discloses the methodology used to determine this information. Disclosures about embedded value methodology would include disclosure of whether, and how, embedded values are affected by estimated returns from assets and by locked-in capital and how those effects are estimated.

### **Material assets, liabilities, income and expense**

IG9 Paragraph 27(b) of the [draft] IFRS requires an insurer to disclose the material assets, liabilities, income and expenses that arise from insurance contracts. If an insurer presents its cash flow statement using the direct method, it also discloses the material cash flows that arise from insurance

contracts. The [draft] IFRS does not require disclosure of specific items. The following paragraphs discuss how an insurer might satisfy those general requirements.

- IG10 Paragraphs 65-69 of IAS 1 *Presentation of Financial Statements* require minimum disclosures on the face of the balance sheet. To satisfy those requirements, an insurer would typically need to present separately on the face of its balance sheet the following amounts arising from insurance contracts:
- (a) liabilities under insurance contracts and reinsurance contracts issued.
  - (b) assets under insurance contracts and reinsurance contracts issued.
  - (c) assets under reinsurance ceded. Under paragraph 10(d)(i) of the [draft] IFRS, these assets are not offset against the related insurance liabilities.
- IG11 Neither IAS 1 nor the [draft] IFRS prescribes the descriptions and ordering of the line items presented on the face of the balance sheet. An insurer could amend the descriptions and ordering to suit the nature of its transactions.
- IG12 Paragraphs 70 and 71 of [draft] IAS 1 require disclosure, either on the face of the balance sheet or in the notes, of subclassifications of the line items presented, classified in a manner appropriate to the entity's operations. The material subclassifications of insurance liabilities that require separate disclosure will depend on the circumstances, but are likely to include items such as:
- (a) unearned premiums.
  - (b) claims reported by policyholders.
  - (c) claims incurred but not reported (IBNR).
  - (d) provisions for premium deficiency or unexpired risk.
  - (e) provisions for future policyholder non-participating benefits.
  - (f) provisions for future policyholder participating benefits.
  - (g) receivables and payables related to insurance contracts (amounts currently due to and from brokers and policyholders related to insurance contracts).
  - (h) non-insurance assets acquired by exercising rights to recoveries (such as salvage and subrogation).

- IG13 Similar subclassifications may also be appropriate for reinsurance assets, depending on their materiality and other relevant circumstances. For assets under insurance contracts and reinsurance contracts issued, an insurer would typically need to distinguish:
- (a) deferred acquisition costs; and
  - (b) intangible assets relating to insurance contracts acquired in business combinations or portfolio transfers.
- IG14 Paragraph 76 of [draft] IAS 1 lists minimum line items that an entity should present on the face of its income statement. It also requires the presentation of additional line items when this is necessary to present fairly the entity's financial performance. To satisfy these requirements, an insurer would typically need to disclose the following amounts on the face of its income statement, if they are material:
- (a) revenue from insurance contracts issued (without any reduction for reinsurance held).
  - (b) income from contracts with reinsurers.
  - (c) policyholder claims and benefits (without any reduction for reinsurance held).
  - (d) expenses arising from reinsurance held.
- IG15 Paragraph 35 of IAS 18 *Revenue* requires an entity to disclose the amount of each significant category of revenue recognised during the period, and specifically requires disclosure of revenue arising from the rendering of services. The [draft] IFRS does not prescribe a particular method for recognising revenue and various models exist:
- (a) Under some models, an insurer recognises premiums earned during the period as revenue and recognises claims arising during the period (including estimates of claims incurred but not reported) as an expense.
  - (b) Under some other models, an insurer recognises premiums received as revenue and at the same time recognises an expense representing the resulting increase in the provision for policyholder benefits.
  - (c) Under yet other models, an insurer reports premiums received as deposit receipts. Its reported revenue comprises charges for items such as mortality, whilst its reported policyholder claims and benefits comprise the claims and benefits related to those charges.

- IG16 Paragraphs 80-89 of [draft] IAS 1 require additional disclosure of various items of income and expense. To satisfy these requirements, an insurer would typically need to disclose the following additional items, if they are material, either on the face of its income statement or in the notes:
- (a) acquisition costs (distinguishing those recognised as an expense immediately from the amortisation of deferred acquisition costs).
  - (b) the effect of changes in estimates and assumptions.
  - (c) for insurance liabilities measured on a discounted basis:
    - (i) accretion of interest to reflect the passage of time; and
    - (ii) the effect of changes in discount rates.
  - (d) distributions to participating and investment-linked policyholders.
- IG17 The above items are not offset against income or expense arising from reinsurers.
- IG18 If an insurer does not adopt uniform accounting policies for the insurance liabilities of its subsidiaries, it may need to disaggregate the disclosures about amounts reported in its financial statements to give meaningful information about amounts determined using different accounting policies.

**Significant assumptions and other sources of measurement uncertainty**

- IG19 Paragraph 27(c) of the [draft] IFRS requires an insurer to describe the process used to determine the assumptions that have the greatest effect on the measurement of assets, liabilities, income and expense arising from insurance contracts and, when practicable, give quantified disclosure of those assumptions. For some disclosures, such as discount rates or assumptions about future mortality improvements or inflation, it will be fairly easy to disclose the assumptions used (aggregated at a reasonable level, where necessary). For other assumptions, such as mortality tables, it may not be practicable to disclose quantified assumptions as there are too many, and it will be more important to describe the process used to generate the assumptions.
- IG20 The description of the process used to determine assumptions might include:
- (a) the objective of the assumptions. For example, an insurer would disclose whether they are intended to be neutral estimates of the most likely or expected outcome ("best estimates") or to provide a

given level of assurance of sufficiency. If they are intended to provide a quantitative or qualitative level of assurance, an insurer discloses that level.

- (b) the source of data used as inputs for the assumptions. For example, an insurer discloses whether the inputs are internal, external or a mixture of the two. For data derived from detailed studies that are not carried out annually, an insurer discloses the criteria used to determine when the studies are updated and the latest update for the most critical assumptions.
- (c) the extent to which the assumptions are consistent with observable market prices or other published information.
- (d) a description of how past experience, current conditions and other relevant benchmarks are taken into account in developing estimates. If a relationship would normally be expected to exist between experience and future results, an insurer explains the reasons for using assumptions that differ from past experience and indicates the extent of the difference.
- (e) a description of how the insurer developed assumptions about future trends, such as mortality improvements or changes in health care costs or litigation awards.
- (f) an explanation of how the insurer identifies correlations between different assumptions.
- (g) the insurer's policy in making allocations or distributions for contracts with discretionary participation features, the related assumptions that are reflected in the financial statements, the nature and extent of any significant uncertainty about the relative interests of policyholders and shareholders in the unallocated surplus associated with those contracts, and the effect on the financial statements of any changes during the period in that policy or those assumptions.
- (h) the nature and extent of material uncertainties affecting assumptions in general as well as specific assumptions. In describing material uncertainties affecting assumptions in general, an insurer explains that future cash flows from insurance contracts are inherently uncertain and that estimates of those cash flows are also subject to uncertainty.

IG21 Disclosure of key assumptions to satisfy paragraph 27(c) of the [draft] IFRS would, together with the sensitivity disclosures discussed below, also satisfy the proposed requirement in paragraph 110 of the Exposure Draft



of the revised IAS 1 *Presentation of Financial Statements* to disclose the 'key assumptions about the future, and other sources of measurement uncertainty, that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year'.

- IG22 An insurer discloses assumptions at a level of aggregation that is useful to users of financial statements.
- IG23 The [draft] IFRS does not prescribe specific assumptions that would be disclosed, because different assumptions will be more significant for different contracts.

### **Changes in assumptions**

- IG24 Paragraph 27(d) of the [draft] IFRS requires an insurer to disclose the effect of changes in assumptions used to measure insurance assets and insurance liabilities. This is consistent with IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, which requires disclosure of the nature and effect of a change in an accounting estimate that has a material effect in the current period or is expected to have a material effect in subsequent periods.
- IG25 Because assumptions are often interdependent, the cumulative impact of changes in different assumptions is unlikely to be a simple sum of the impacts of the individual changes. Therefore, analysis of changes by assumption may be arbitrary to some extent. If practicable, an insurer discloses separately the impact of changes in different assumptions, particularly if changes in some assumptions have an adverse effect and others have a beneficial effect. An insurer also describes the impact of interdependencies between assumptions and the resulting limitations of any analysis of the effect of changes in assumption.
- IG26 An insurer discloses the effects of changes in assumptions both before and after the impact of reinsurance held.

### **Changes in insurance liabilities and related items**

- IG27 Paragraph 27(e) of the [draft] IFRS requires an insurer to disclose movements in aggregate insurance liabilities. It also requires disclosure of movements in aggregate reinsurance assets. The movements would typically include:
- (a) the carrying amount at the beginning and end of the period.
  - (b) additional insurance liabilities incurred during the period, including increases in existing insurance liabilities.

- (c) amounts used (ie incurred and charged against the insurance liabilities) during the period.
  - (d) unused amounts reversed during the period. In disclosing the movements in insurance liabilities, an insurer does not use unused amounts relating to one insurance liability as an undisclosed way of increasing another insurance liability.
  - (e) income and expense included in profit or loss.
  - (f) liabilities acquired from, or transferred to, other insurers.
  - (g) foreign exchange translation differences.
- IG28 An insurer discloses the movements in insurance liabilities and reinsurance assets in all prior periods for which it reports full comparative information.
- IG29 Paragraph 27(e) of the [draft] IFRS also requires an insurer to disclose movements in deferred acquisition costs, if applicable. The reconciliation would typically disclose:
- (a) the carrying amount at the beginning and end of the period.
  - (b) the amounts incurred during the period.
  - (c) the amortisation for the period.
  - (d) impairment losses recognised during the period.
  - (e) other material movements categorised by cause and type.
- IG30 An insurer may have recognised intangible assets related to insurance contracts acquired in a business combination or portfolio transfer. IAS 38 *Intangible Assets* contains disclosure requirements for intangible assets, including a requirement to give a reconciliation of movements in intangible assets. The [draft] IFRS does not require additional disclosures about these assets.

### **Amount, timing and uncertainty of future cash flows (paragraphs 28 and 29 of the [draft] IFRS)**

- IG31 The risk disclosures are based on two foundations:
- (a) There should be a balance between quantitative and qualitative disclosures, enabling users to understand the nature of risk exposures and the potential impact of those exposures.

- (b) Disclosures should be consistent with how management perceives its activities and risks, and the models and techniques that management uses to manage those risks. This is likely:
  - (i) to have more predictive value than information based on assumptions and techniques that are not those used by management, for instance, in predicting the ability of the insurer to react to adverse situations.
  - (ii) to be more effective in adapting to the continuing change in risk measurement and management techniques and developments in the external environment over time.

IG32 An insurer groups insurance contracts into broad classes in ways that are appropriate for the nature of the information to be disclosed, taking into account matters such as the risks covered and the characteristics of the contracts. The classes may often correspond to classes established for legal or regulatory purposes, but the [draft] IFRS does not require this.

IG33 Under IAS 14 *Segment Reporting*, the identification of reportable segments reflects differences in the risks and returns of an entity's products and services. IAS 14 takes the position that the segments identified in an organisational and management structure and internal financial reporting system normally provide an appropriate segmentation for financial reporting. An insurer could adopt a similar approach to identify classes of insurance contracts for disclosure purposes, although it may be appropriate to disaggregate disclosures down to the next level. For example, if an insurer identifies life insurance as a reportable segment for IAS 14, it may be appropriate to report separate information about, say, life insurance, annuities in the accumulation phase and annuities in the payout phase.

IG34 Paragraph 45 of the June 2002 Exposure Draft of proposed improvements to IAS 32 gives the following guidance on the level of detail to be disclosed about financial instruments, which is also appropriate for insurance contracts.

'Determination of the level of detail to be disclosed about particular financial instruments requires the exercise of judgement taking into account the relative significance of those instruments. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring significant information as a result of too much aggregation. For example, when an entity is party to a large number of financial instruments with similar characteristics and no single contract is individually significant, summarised information by reference to particular

classes of instruments is appropriate. On the other hand, specific information about an individual instrument may be important when that instrument represents, for example, a significant component of an entity's capital structure.'

- IG35 In identifying classes for separate disclosure, an insurer considers the need to indicate the level of uncertainty associated with the risks underwritten, to inform users whether reasonable estimates are likely to be within a wider or a narrower range. For example, an insurer discloses information about exposures where there are significant amounts of provisions for claims incurred but not reported (IBNR) or where outcomes and risks are unusually difficult to assess (eg asbestos).
- IG36 An insurer gives sufficient information about the classes identified to permit a reconciliation to relevant line items on the balance sheet.

### **Risk management objectives and policies for mitigating insurance risk**

- IG37 Paragraph 29(a) of the [draft] IFRS requires an insurer to disclose its objectives in managing risks arising from insurance contracts and its policies for mitigating risk. An insurer discloses, for example:
- (a) its policies for accepting insurance risks, including selection and approval of risks to be insured, use of limits and use of options and avoiding undue concentrations of risk; the underwriting strategy to ensure that there are appropriate risk classification and premium levels. These disclosures include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the insurance contracts and their relative significance to the insurer.
  - (b) the methods it uses to assess and monitor insurance risk exposures both for individual types of risks insured and overall, such as internal risk measurement models, sensitivity analyses, scenario analyses, and stress testing, and how it integrates them into its operating activities. Useful disclosure might include a summary description of the approach used, associated assumptions and parameters (including confidence intervals, computation frequencies and historical observation periods) and strengths and limitations of the approach.
  - (c) methods it employs to monitor claims and to limit or transfer insurance risk exposures, such as retention limits and the use of reinsurance.

- (d) the extent to which insurance risks are assessed and managed on an entity-wide basis, including any mechanisms for internal risk transfer.
- (e) asset and liability management (ALM) techniques.
- (f) commitments received (or given) to issue (contribute) additional debt or equity capital when specified events occur.

### **Terms and conditions of insurance contracts**

IG38 Paragraph 29(b) of the [draft] IFRS requires an insurer to disclose those terms and conditions of insurance contracts that have a material effect on the amount, timing and certainty of future cash flows arising from insurance contracts. To achieve this, an insurer discloses the following for each broad class of insurance liabilities, and reinsurance assets held:

- (a) the nature of the risk covered, by giving a brief summary description of the class (such as annuities, pensions, other life insurance, motor, property and liability).
- (b) concentrations of insurance risk, interest risk, credit risk or foreign exchange risk and the extent to which reinsurance or policyholder participation features mitigate those risks (see paragraphs IG44-IG47 for further discussion).
- (c) a summary of significant guarantees, and of the levels at which guarantees of market prices or interest rates are likely to alter the insurer's cash flows significantly.
- (d) claims development information (see paragraphs IG48 and IG49 for further discussion).
- (e) the basis for determining investment returns credited to policyholders, such as whether the returns are fixed, based contractually on the return of specified assets or partly or wholly subject to the insurer's discretion.
- (f) the general nature of participation features whereby policyholders share in the performance (and related risks) of individual contracts, pools of contracts or entities, including the general nature of any formula for the participation and the extent of any discretion held by the insurer.

- IG39 An insurer also discloses the following information, which need not be disaggregated by broad classes:
- (a) an analysis of the recognised insurance liabilities, and reinsurance assets, by the period in which the net cash inflows and outflows are estimated to occur. The analysis is for the following periods after the balance sheet date:
    - (i) not later than one year;
    - (ii) later than one year and not later than two years;
    - (iii) later than two years and not later than three years;
    - (iv) later than three years and not later than four years;
    - (v) later than four years and not later than five years; and
    - (vi) later than five years. If material amounts are estimated to occur after more than five years, an insurer may need to give further analysis in bands of, for example, five years.
  - (b) a summary narrative description of how the amounts in (a) would change if each policyholder exercised lapse or surrender options in the way that is least beneficial to the insurer.
  - (c) the average effective interest rate implicit in the measurement of insurance liabilities for each period described in (a).
  - (d) the amount of insurance liabilities and insurance assets denominated in foreign currencies.
  - (e) the sensitivity of reported profit or loss and equity to changes in key assumptions (see paragraphs IG41-IG43 for further discussion).
  - (f) the terms of coverage by government or other guarantee funds that aim to protect policyholders, and the terms of any obligation or contingent obligation for the insurer to contribute to those funds (see also IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).
  - (g) segregation requirements that are intended to protect policyholders by restricting the use of some of the insurer's assets.

## Insurance risk

- IG40 Paragraph 29(c) of the [draft] IFRS requires disclosures about insurance risk. Disclosures to satisfy this requirement would build on the following foundations:
- (a) Information about insurance risk is consistent with the information provided internally to the board of directors and chief executive officer, so that users can assess the insurer's financial position, performance and cash flows 'through the eyes of management.'
  - (b) Information about risk exposures reports exposures both gross and net of reinsurance (or similar items, such as catastrophe bonds issued), as well as other risk mitigating elements, such as policyholder participation features.
  - (c) If an insurer reports quantitative information about insurance risk it discloses the methods used, the strengths and limitations of those methods, the assumptions made, and the extent to which the risk is reduced by reinsurance, policyholder participation and other mitigating elements.
  - (d) Insurers may need to classify risk along more than one dimension. For example, life insurers may need to classify contracts by both the level of mortality risk and the level of investment risk. It may sometimes be convenient to display this information in a matrix format.
  - (e) If an insurer's risk exposures at the reporting date are unrepresentative of its exposures during the period, it indicates that fact.
  - (f) The disclosures inform users that there is inherent uncertainty about both the reliability of the estimates and assumptions made in measuring insurance liabilities (measurement uncertainty, ie the measurement might be in error) and inherent variability of the item being measured (even if the measurement is perfectly reasonable, the actual outcome may fluctuate around the mid-point of the possible outcomes).
  - (g) The [draft] IFRS also requires specific disclosure about:
    - (i) the sensitivity of reported profit or loss and equity to changes in variables that have a material effect on them.
    - (ii) material concentrations of insurance risk.
    - (iii) the development of prior year insurance liabilities.

### Sensitivity analysis

- IG41 Paragraph 29(c)(i) of the [draft] IFRS requires disclosure about the sensitivity of reported profit or loss and equity to changes in variables that have a material effect on them. An insurer gives qualitative, and preferably also quantitative, sensitivity analysis. If feasible without undue cost or effort, an insurer indicates the impact of correlations between key variables. Although sensitivity tests can provide valuable information for users, such tests have limitations. An insurer discloses the strengths and limitations of sensitivity analyses performed.
- IG42 An insurer avoids giving a misleading sensitivity analysis if there are significant non-linearities in sensitivities to variables that have a material effect. For example, if a change of 1 per cent in a variable has a negligible effect, but a change of 1.1 per cent has a material effect, it would be misleading to disclose the effect of a 1 per cent change without giving further explanation.
- IG43 Sensitivity analysis helps to meet the requirement to disclose information about the amount, timing and uncertainty of cash flows. To permit meaningful aggregation, the required sensitivity disclosure does not refer directly to the cash flows but instead focuses on summary indicators, namely reported profit or loss and equity.

### Concentrations of insurance risk

- IG44 Paragraph 29(c)(ii) of the [draft] IFRS refers to the need to disclose material concentrations of insurance risk. Identification of material concentrations requires judgement by management taking into account the circumstances of the insurer and its contracts. Such concentration could arise from, for example:
- (a) a single insurance contract, or a small number of related contracts, for instance, when an insurance contract covers low-frequency, high-severity risks such as earthquakes.
  - (b) single incidents that expose an insurer to risk under several different types of insurance contract. For example, a major terrorist incident could create exposure under life insurance contracts, property insurance contracts, business interruption and civil liability.
  - (c) exposure to unexpected changes in trends, for example, unexpected changes in human mortality or in policyholder behaviour.



- (d) exposure to unexpected major changes in financial market conditions that cause options held by policyholders to come into the money. For example, life insurers in many countries have suffered significant losses in recent years under interest rate and annuity guarantees that came into the money when interest rates declined to unexpectedly low levels.
- (e) significant litigation or legislative risks that could cause a large single loss, or have a pervasive effect on many contracts.
- (f) correlations and interdependencies between different risks.
- (g) significant non-linearities, such as stop-loss or excess of loss features, especially if a key variable is close to a level that triggers a significant change in future cash flows.
- (h) geographical and sectoral concentrations. The guidance in IAS 14 *Segment Reporting* may help an insurer to identify industry and geographical segments where risk concentrations arise.

IG45 Disclosure of concentrations of insurance risk includes a description of the shared characteristic that identifies each concentration and an indication of the maximum exposure associated with all insurance liabilities sharing that characteristic. An insurer gives this disclosure both before and after the effect of reinsurance held.

IG46 Some suggest that an insurer—particularly a general insurer—should disclose the probable maximum loss (PML) that it expects to suffer if a reasonably extreme event occurs. For example, an insurer might disclose the loss that it would suffer from a severe earthquake of the kind that would be expected to recur every one hundred years, on average. Given the lack of a widely agreed definition of PML, the [draft] IFRS does not require disclosure of PML or similar measures. If an insurer discloses such measures, it gives a clear description of the basis used for determining them (including associated assumptions and parameters) and of their strengths and limitations.

IG47 Disclosure about an insurer's historical performance on low-frequency, high-severity risks may help users to assess cash flow uncertainty associated with those risks. Consider an insurance contract that covers an earthquake that is expected to happen every 50 years, on average. If the insured event occurs during the current contract period, the insurer will report a large loss. If the insured event does not occur during the current period, the insurer will report a profit. Without adequate disclosure of the source of historical profits, it could be misleading for the insurer to report 49 years of reasonable profits, followed by one large loss; users may misinterpret the insurer's long-term ability to generate cash flows over the

complete cycle of 50 years. Therefore, it may be helpful to describe the extent of the exposure to risks of this kind and the period since the last event of this kind occurred.

### **Claims development**

- IG48 Paragraph 29(c)(iii) of the [draft] IFRS requires disclosure of claims development information (subject to transitional relief in paragraph 34). The disclosure reconciles this information to amounts reported in the balance sheet. An insurer discloses unusual claims expenses or developments separately, allowing users to identify the underlying trends in performance.
- IG49 IG Example 4 shows one possible format for presenting claims development information.

**IG Example 4: Disclosure of claims development**

This example illustrates a possible format for a claims development table for a general insurer. The top half of the table shows how the insurer's estimates of total claims for each underwriting year develop over time. For example, at the end of 20X1, the insurer estimated that it would pay claims of 680 for insured events relating to insurance contracts underwritten in 20X1. By the end of 20X2, the insurer had revised the estimate of cumulative claims (both those paid and those still to be paid) to 673.

The lower half of the table reconciles the cumulative claims to the amount appearing in the balance sheet. First, the cumulative payments are deducted to give the cumulative unpaid claims for each year on an undiscounted basis. Second, if the claims liabilities are discounted, the effect of discounting (both for the time value of money and risk) is deducted to give the carrying amount in the balance sheet.

<i>Underwriting year</i>	<i>20X1</i>	<i>20X2</i>	<i>20X3</i>	<i>20X4</i>	<i>20X5</i>	<i>Total</i>
Estimate of cumulative claims:						
At end of underwriting year	680	790	823	920	968	
One year later	673	785	840	903		
Two years later	692	776	845			
Three years later	697	771				
Four years later	702					
Estimate of cumulative claims	702	771	845	903	968	
Cumulative payments	<u>(702)</u>	<u>(689)</u>	<u>(570)</u>	<u>(350)</u>	<u>(217)</u>	
	-	82	275	553	751	1,713
Effect of discounting	-	<u>(14)</u>	<u>(68)</u>	<u>(175)</u>	<u>(285)</u>	<u>(547)</u>
Present value recognised in the balance sheet	<u>-</u>	<u>68</u>	<u>207</u>	<u>378</u>	<u>466</u>	<u>1,166</u>

**Interest risk and credit risk**

- IG50 Paragraph 29(d) of the [draft] IFRS requires an insurer to disclose information about interest risk and credit risk. The information required is the same as that required by IAS 32 *Financial Instruments: Disclosure and Presentation* (to the extent not already covered by the disclosures discussed above).
- IG51 If lapse behaviour is likely to be sensitive to interest rates, an insurer discloses that fact and states whether the disclosures about interest risk reflect that interdependence.
- IG52 An insurer discloses information about the extent to which policyholder participation features mitigate or compound interest risk.
- IG53 For an insurer, disclosure about credit risk is likely to be particularly important for reinsurance contracts held and for credit risk assumed under credit insurance contracts and financial guarantees. Balances due from insurance brokers may also be subject to credit risk.

**Material exposures to interest risk or market risk under embedded derivatives**

- IG54 Although IAS 39 *Financial Instruments: Recognition and Measurement* requires an insurer to measure some embedded derivatives at fair value, this requirement does not apply to an embedded derivative that itself meets the definition of an insurance contract (for example, guaranteed annuity options and guaranteed minimum death benefits). Paragraph 29(e) of the [draft] IFRS would require an insurer to disclose information about material exposures to interest risk or market risk under embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivative at fair value.
- IG55 An example of a contract containing a guaranteed annuity option is one in which the policyholder pays a fixed monthly premium for thirty years. At maturity, the policyholder can elect to take either (a) a lump sum equal to the accumulated investment value or (b) a lifetime annuity at a rate guaranteed at inception (ie when the contract started). If the policyholder elects to receive the annuity, the insurer could suffer a significant loss if interest rates decline substantially or if the policyholder lives much longer than the average. The insurer is exposed to both interest risk and significant insurance risk (mortality risk) and that exposure starts from inception, because the insurer fixed the price for mortality risk at that date.

Therefore, the contract is an insurance contract from inception. Moreover, the embedded guaranteed annuity option itself meets the definition of an insurance contract, and so separation is not required.

- IG56 An example of a contract containing minimum guaranteed death benefits is one in which the policyholder pays a monthly premium for 30 years. Most of the premiums are invested in a mutual fund. The rest is used to buy life cover and to cover expenses. On maturity or surrender, the policyholder receives back the value of the mutual fund units at that date. On death before final maturity, the policyholder's estate receives the greater of (a) the current unit value and (b) a fixed amount. This contract could be viewed as a hybrid contract comprising (a) a mutual fund investment and (b) an embedded life insurance contract that pays a death benefit equal to the fixed amount less the current unit value (but zero if the current unit value is more than the fixed amount).
- IG57 Both these embedded derivatives meet the proposed definition of an insurance contract because the insurance risk is significant. However, in both cases interest risk or market risk may be much more significant than the mortality risk. If interest rates or equity markets fall substantially, these guarantees would be well in the money. Given the long-term nature of the guarantees and the size of the exposures, an insurer might face extremely large losses on a fair value basis. Therefore, an insurer places particular emphasis on disclosures about such exposures.
- IG58 The disclosures about such exposures could include the sensitivity analysis discussed above, the fair value of the embedded derivative and information about the levels when these exposures start to have a material effect on the fair value of insurance liabilities.

### **Key performance indicators**

- IG59 Some insurers present disclosures about what they regard as key performance indicators, such as lapse and renewal rates, total sum insured, average cost per claim, average number of claims per contract, new business volumes, claims ratio, expense ratio and combined ratio. Such disclosures may be a useful way for an insurer to explain its financial performance during the period and to give an insight into the amount, timing and uncertainty of its future cash flows. The [draft] IFRS permits but not does require such disclosures.

## **Fair value of insurance liabilities and insurance assets (paragraph 30 of the [draft] IFRS)**

- IG60 Paragraphs 30 and 33 of the [draft] IFRS require an insurer to disclose the fair value of its insurance liabilities and insurance assets from 31 December 2006. The Board acknowledges the need for further guidance on fair value and will develop it as phase II of the project progresses.
- IG61 In disclosing the fair value of its insurance liabilities, an insurer explains that the fair value relates not only to the amounts recognised in its balance sheet as insurance liabilities, but also to deferred acquisition costs (if any). The draft IFRS does not require an insurer to disclose the fair value of deferred acquisition costs (if any) separately from the fair value of other components of its insurance liabilities.