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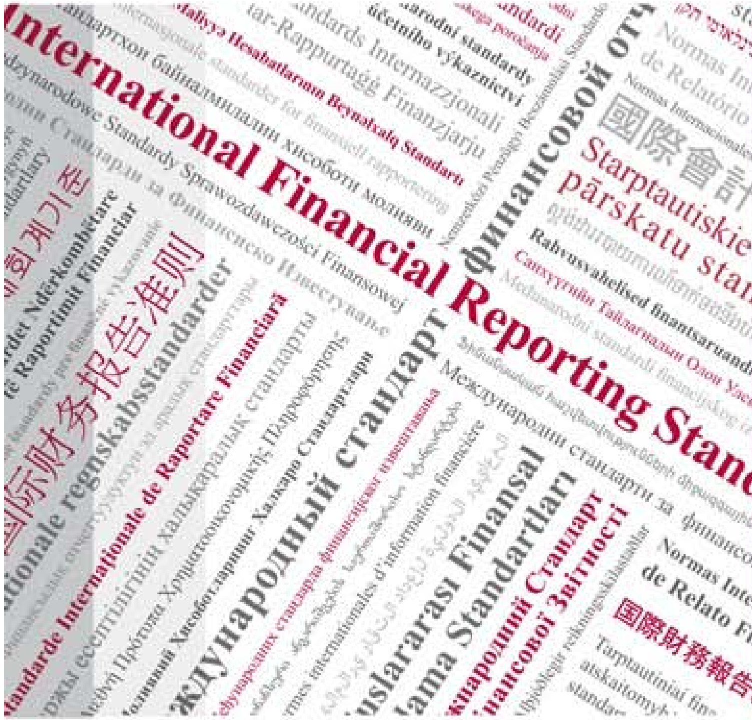
Open Forum:
Insurance Accounting - A New Era II?

Chairman: Derek Wright

Accounting Proposals for Insurance Contracts
Guest Speaker: Andrea Pryde, IASB Insurance Contracts Project Leader

Preliminary views on Exposure Draft and implications
Kamran Foroughi and Anthony Coughlan, Financial Reporting Group

12 September 2013



Accounting proposals for insurance contracts

Background to insurance contract proposals: No comprehensive IFRS today

IFRS 4 *Insurance Contracts* is an interim Standard

- Permits continuation of a wide variety of accounting models
- Requires disclosures to enhance comparability and to understand reported amounts
- Does not facilitate transparency

We have listened and responded to your concerns

- Improves representation of some aspects
- Introduces practical accommodations to conceptual approaches
- Provides additional clarification and guidance

Revised Exposure Draft (ED) next step toward final Standard

- Builds on previous consultations
- Seeks feedback on changes to previous proposals
- Focuses on operational and reporting complexity of revised proposals

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Other relevant IASB projects

Conceptual framework

- Sets out concepts underlining the preparation and presentation of financial statements.
- Current stage: Discussion Paper issued in 2013. Comment period ends 14 January 2014

Financial instruments

- Phase 1: **Classification and measurement**. In May IASB started to discuss feedback on proposed amendments.
- Phase 2: **Impairment methodology**. IASB is starting re-deliberations in September. The work will not finish in 2013.
- Phase 3**: Hedge accounting**. IASB finished deliberations and will publish the final chapter by the end of 2013.

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Background to insurance contract proposals: Improving existing accounting

Existing issues		How our proposals improve accounting
Variety of accounting treatments depending on type of contract and type of company that issues the contracts	→	Consistent accounting for all insurance contracts by all companies (not just insurance companies)
Estimates for long duration contracts not updated	→	Estimates updated to reflect current market-based information
Discount rate based on estimates of investment returns does not reflect economic risks of insurance contract	→	Discount rate reflects characteristics of the cash flows of the contract
Lack of discounting for measurement of some contracts	→	Measurement of insurance contract reflects discounting where significant
Little information about economic value of embedded options and guarantees	→	Measurement reflects information about full range of possible outcomes

Who is affected by these proposals?

- Any entity that issues:
  - All types of insurance contracts
  - Some types of fixed-fee service contracts
  - Third-party product warranties
- In addition, if an entity issues insurance contracts, the proposals also apply to:
  - Investment contracts that contain discretionary participation features
  - Reinsurance contracts held (ie where the entity is the cedant)

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Our proposals: Current, market-consistent measurement of insurance contracts

Measurement of insurance contract has two components:

Net contract asset or liability*

Contractual service margin:
Expected contract profit

Fulfilment cash flows

Future cash flows: Expected cash flows from premiums and claims and benefits

Risk adjustment: An assessment of the uncertainty about the amount of future cash flows

Discounting: An adjustment that converts future cash flows into current amounts

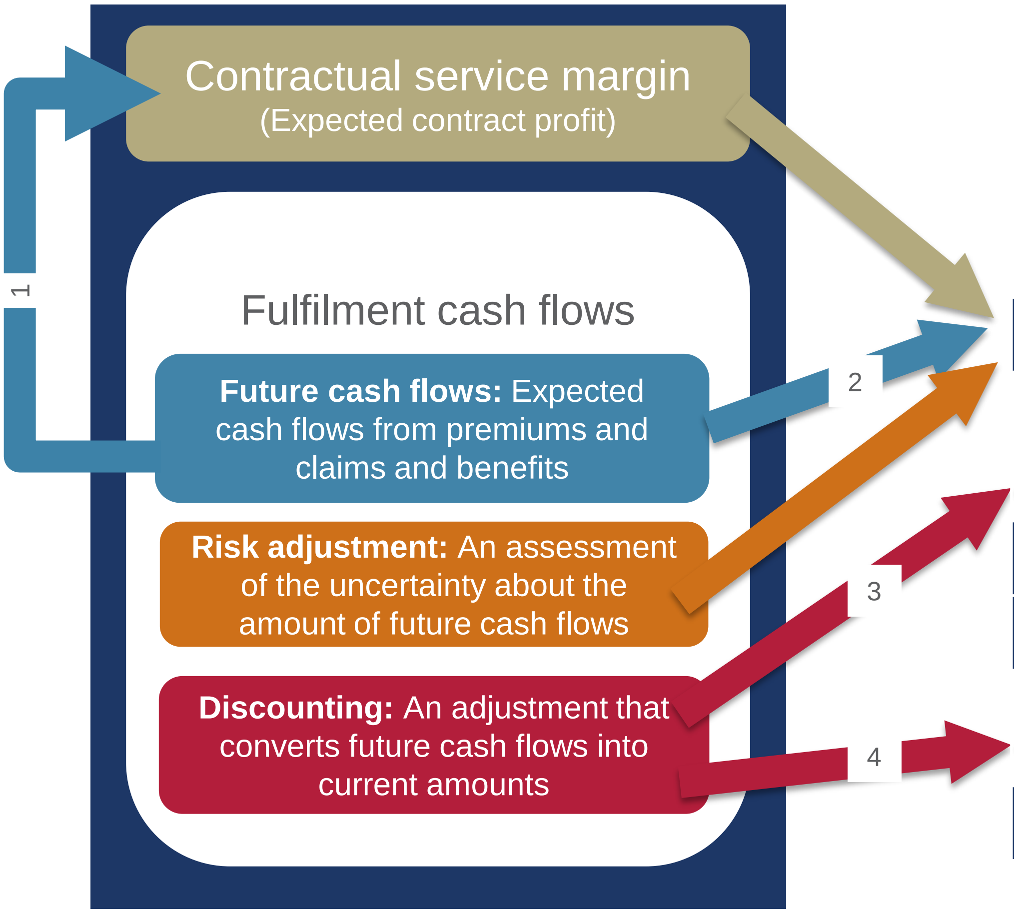
Contractual service margin represents expected contract profit

Fulfilment cash flows represent a current, updated estimate of amounts the company expects to collect from premiums and pay out for claims, benefits and expenses, adjusted for risk and time value of money

* Depending on the timing of payments relative to coverage provided

Our proposals: Up-to-date information about performance

Net contract asset or liability



Statement of Comprehensive Income

	20XX
Insurance contracts revenue	X
Incurred claims and expenses	(X)
Operating result	**X**
Investment income	X
Interest on insurance liability	(X)
Investment result	**X**
Profit or loss	**X**
Effect of discount rate changes on insurance liability	(X)
Total comprehensive income	**XX**

1. Changes in estimates relating to future services
2. All other expected cash flow changes
3. Based on a cost view
4. Based on a current view

Our proposals: What will disclosures show?

Amounts

- Expected present value of future payments & receipts
- Changes in risk during the period
- Changes in expected contract profit
- Effects of new contracts written in the period

Judgements

- Processes for estimating inputs and methods used
- Effect of changes on methods and inputs used
- Explanation of reason for change, identifying type of contracts affected

Risks

- Nature and extent of risks arising from insurance contracts
- Extent of mitigation of risks arising from reinsurance and participation features
- Quantitative information about exposure to credit, market and liquidity risk

Impact for different types of insurance contracts

The same principles apply to all types of insurance contracts

Life contracts

- Current, updated estimates of cash flows
- Explicit estimates of risk
- Discount rates that fully reflect insurance contract cash flow characteristics
- Reporting revenue for services rather than cash-based premium information
- Elimination of deferred acquisition cost assets

Non-life contracts

- Restrictions on eligibility for premium allocation approach
- Little change to reporting during coverage period
- More change to accounting for incurred claims
  - risk adjustment
  - discounting
  - other comprehensive income

Reinsurance contracts held

- Many reinsurance contracts eligible for premium allocation approach
- Reported using consistent methodology as for direct contracts

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IASB seeks feedback on targeted aspects

Measurement proposals

- Changes in estimates relating to expected contract profit for providing coverage recognised over remaining period
- Measurement and presentation exception when no economic mismatch is possible

Presentation proposals

- Align to presentation of revenue required for other types of contracts with customers
- Interest expense is amortised cost-based in profit or loss, current value-based on balance sheet

Approach to transition

- Apply Standard retrospectively if practicable, or with specified simplifications if not practicable

Balancing benefits against complexity

Better reflection of the economics of the contracts

Costs of greater operational complexity for preparers and of understanding more complex information for users

Impact on different types of contract

	Life contracts	Non-life contracts	Reinsurance contracts (cedants)
Changes in estimates relating to future profits	Most impact	Not relevant if using premium allocation approach	Not relevant if using premium allocation approach
Measurement and presentation exception when no economic mismatch is possible	Significant impact for eligible contracts	Not relevant if using premium allocation approach	Not relevant if using premium allocation approach
Insurance contract revenue	Significant impact	Less impact as similar to existing practice	Less impact if using the premium allocation approach
Interest expense in amortised cost basis	Significant impact	Significant impact for the liability for incurred claims	Significant impact
Transition	Significant impact	Significant impact for the liability for incurred claims	Significant impact

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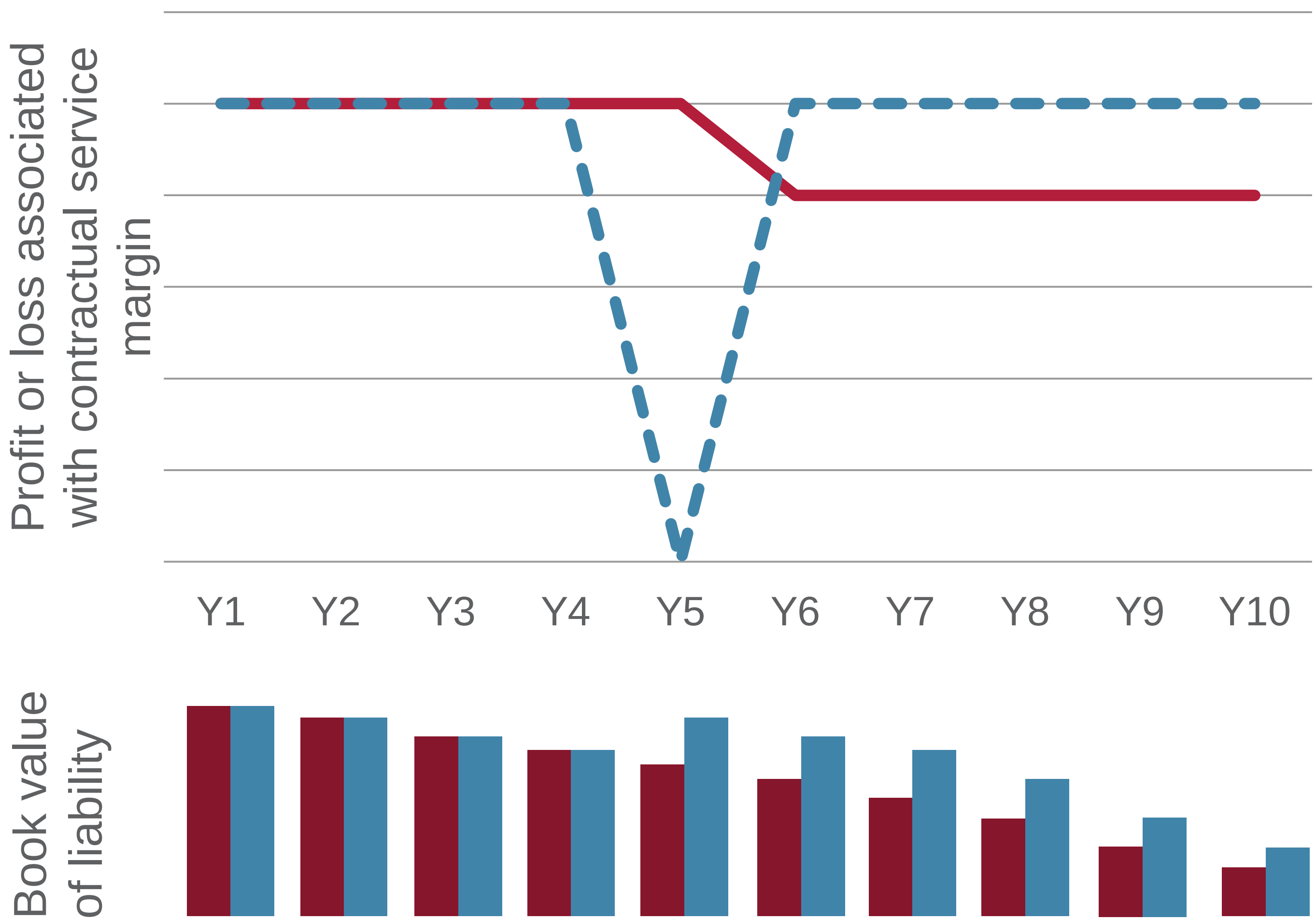
Issue: Adjustments for changes in cash flows relating to future insurance coverage

Changes in estimates of cash flows affect the amount of profit the company expects to earn for providing future services. Should such changes in estimates be reported in the period of change or as future services are provided?

Pattern of profit recognition after change in estimates relating to future insurance coverage



Our proposal
Adjust contractual service margin for changes in estimates of expected cash flows related to future services

2010 Exposure Draft
Effects of change in estimates are recognised immediately in profit or loss

Change since 2010 ED: Adjustments for changes in cash flows relating to future insurance coverage

Our proposal

Adjust contractual service margin for changes in future cash flows related to future services

- Better reflects that these changes affect expected contract profit for providing future services
- Results in consistency between initial and subsequent measurement of contractual service margin
- For periods after change in estimate, updated estimates included in future operating results as services are provided
- Consistent with revenue recognition model and premium-allocation approach

2010 proposal

- Changes in estimates for both past and future services represent economic events during the period and should immediately be recognised in profit or loss
- Immediately recognising in profit or loss changes in expected future profits provides transparent, relevant information of changes in estimates since entering into the contract
- For periods after change in estimates, profit based on original estimates for future services
- Consistent with balance sheet view and IFRS 9

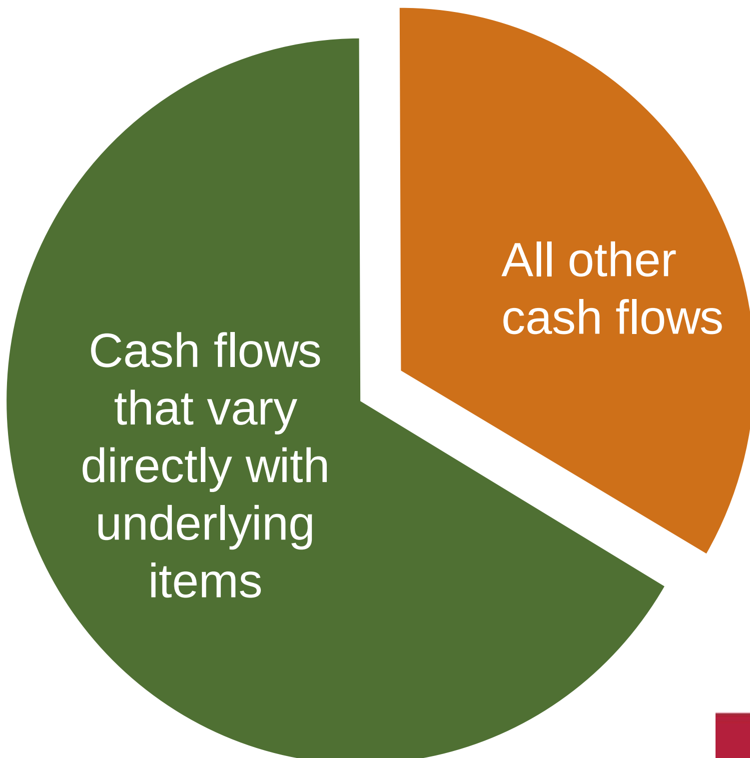
Issue: Contracts that have cash flows that are expected to vary directly with returns on underlying items

If an insurance contract specifies a link to returns on underlying items the company is required to hold, there can be no economic mismatch between the cash flows that vary directly with returns on underlying items and those returns.

How do we portray that fact?

Measurement and presentation exception

Applies when there can be no economic mismatch between the insurance contract and assets backing that contract. This occurs when the contract requires the entity to hold underlying items and specifies a link to returns on those underlying items.



Measured using general requirements of the Standard. However, all changes in value of cash flows that vary indirectly with the underlying items are presented in profit or loss

Eliminate mismatch by measuring and presenting cash flows in the same way as the underlying items.

Change since 2010 ED: Contracts that have cash flows that are expected to vary directly with returns on underlying items

Our proposal

- Measures cash flows that arise from underlying items on the same basis as underlying items. This reflects that the entity will fulfil the obligation by delivering a value equivalent to the underlying item to the policyholder
- Aligns accounting with economics:
  - No accounting mismatch when there is no possibility of economic mismatch
  - Portrays economic risks borne by the entity

2010 proposal

- Measures insurance contract liability using fulfilment cash flows (with no adjustment to reflect contractual linkage to underlying items). This would:
  - result in measuring all insurance contracts on same current value basis
  - substantially eliminate measurement mismatches when underlying items are measured at fair value

Issue: Insurance contract revenue and expense

Should a company show information about gross performance rather than net margin?

If gross performance is more useful, should information be consistent with revenue and expense for other transactions?

Proposed change to presentation does not affect operating result

2010 Exposure draft:
Summarised margin presentation

Change in contractual service margin
+ Change in risk adjustment
± Experience adjustments

= Operating result

Change in contractual service margin
+ Change in risk adjustment
± Claims/expenses expected
- Claims/expenses incurred

= Operating result

Combine

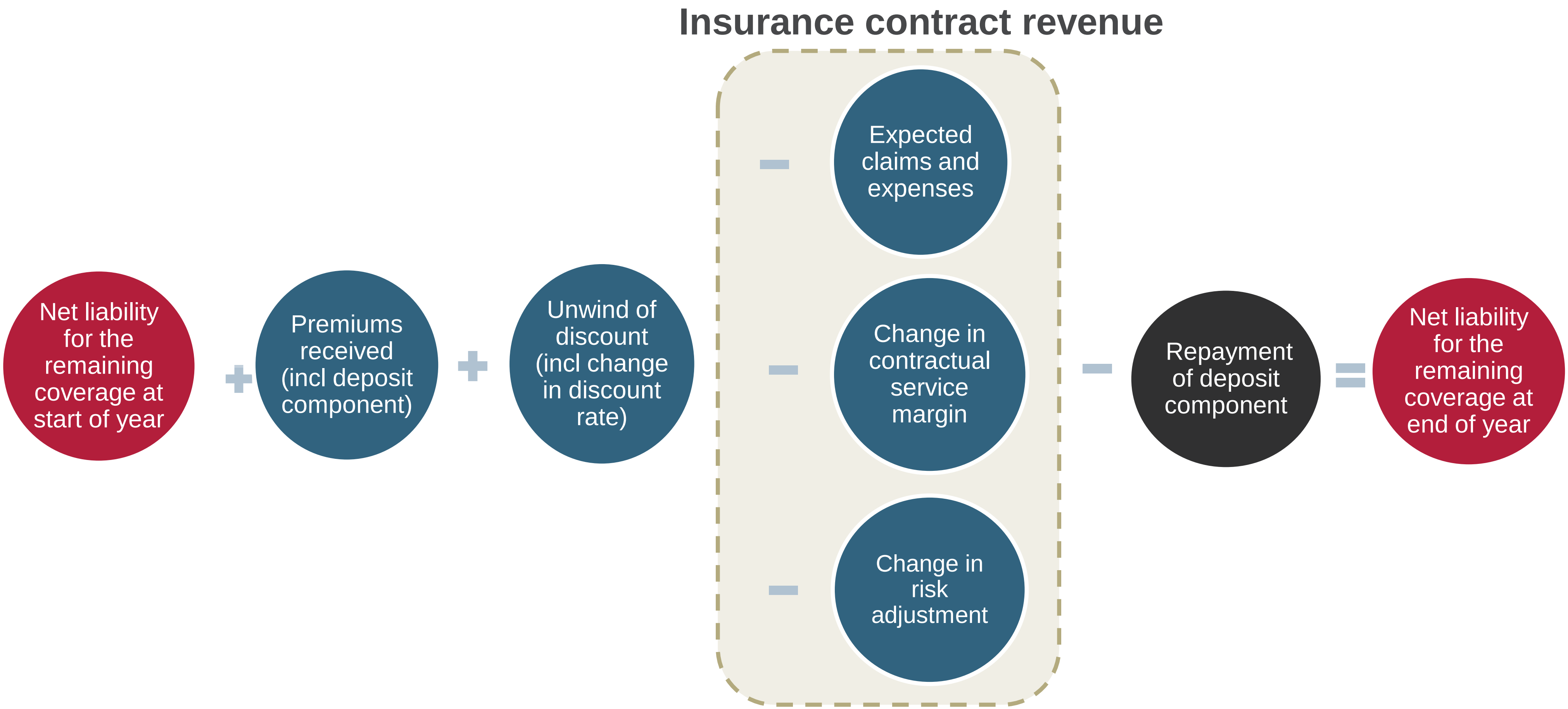
Combine

Our proposals:
Gross performance metrics

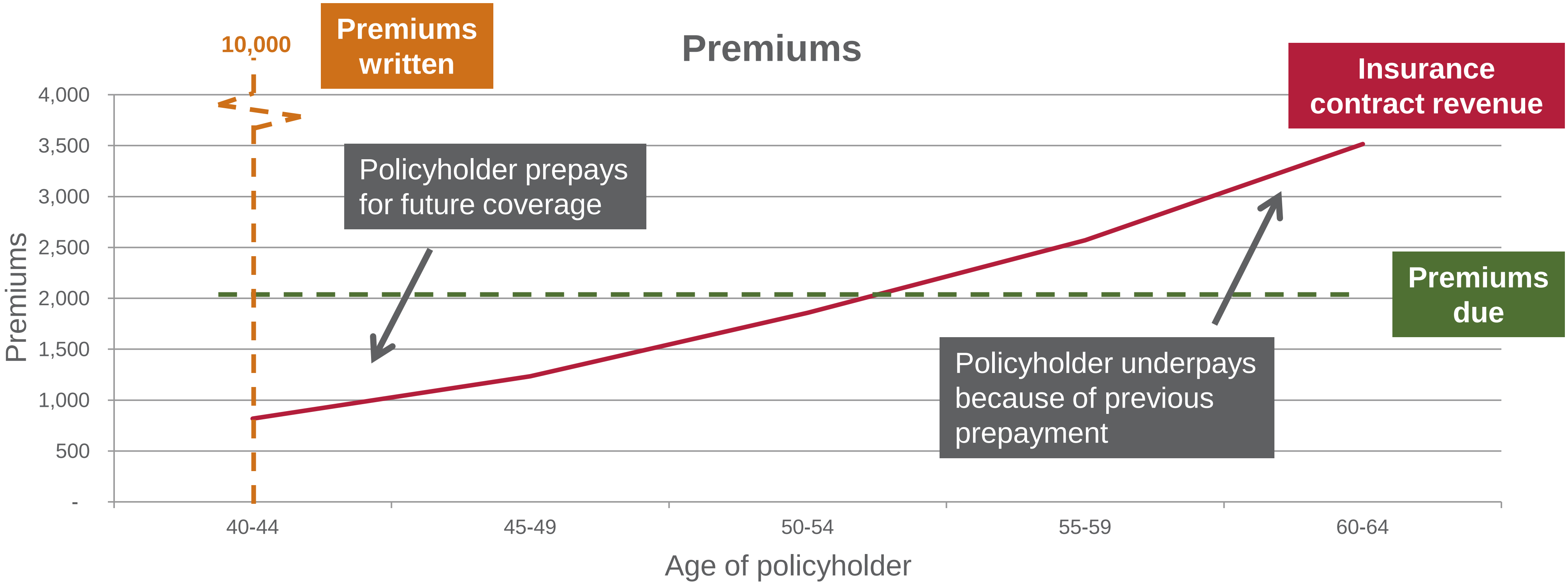
Insurance contracts revenue
- Claims/expenses incurred

= Operating result

How revenue relates to changes in the measurement of the insurance contract

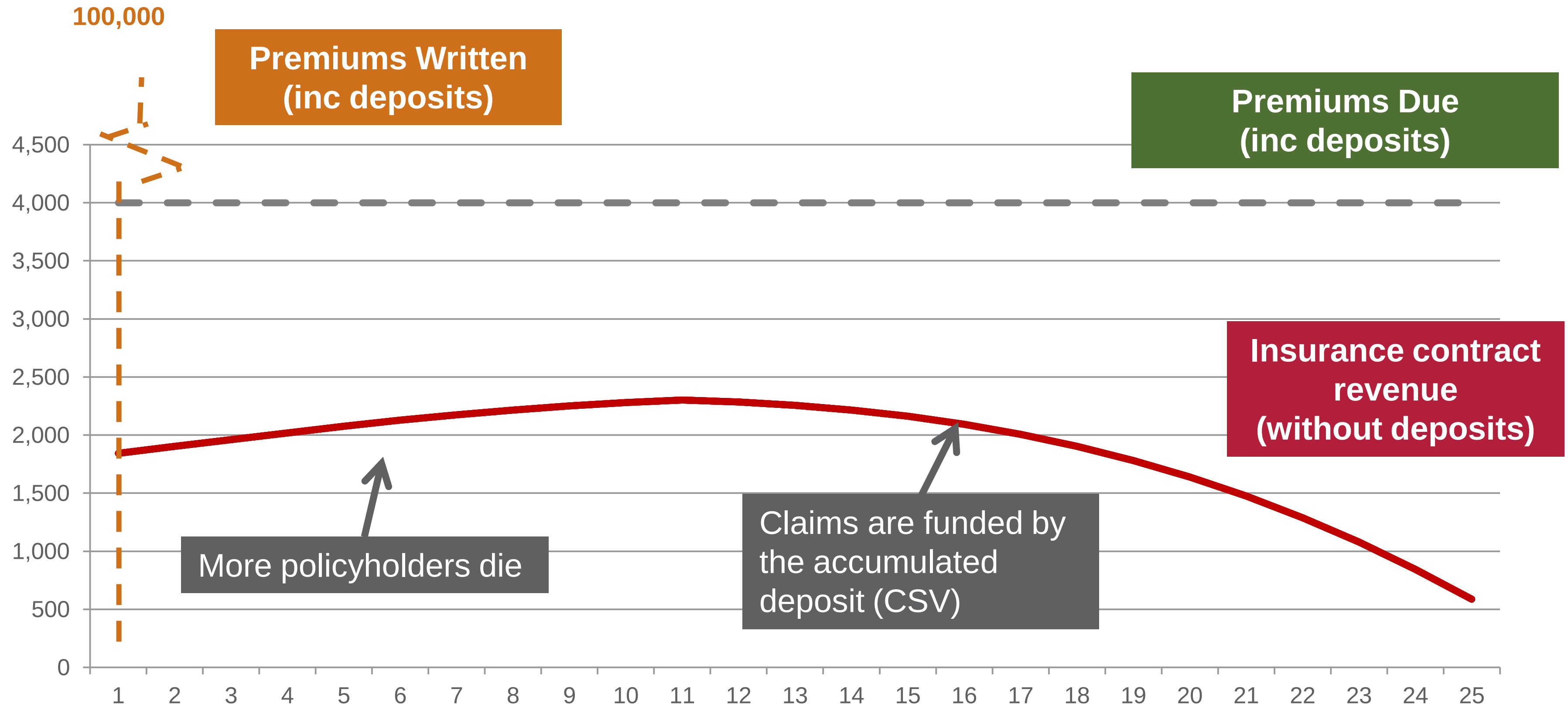


What is revenue from insurance contracts? Level premium term life contract



- Assumptions:
  - Portfolio of term life contracts issued to 40 year olds
  - Expected claims/benefits are 10,000; premiums are due 2,000 each 5 year period
  - Ignores premiums ‘allocated’ to the margins, payment of acquisition costs and payment of maintenance and benefits expense
  - Assumes no lapses, no discounting and no investment component

What is revenue from insurance contracts? Level premium term life contract with deposit



Assumptions:

- Portfolio of life contracts issued to 40 year olds for 25 years, annual premiums total 4,000
- CU 100 on death or maturity
- Deposit (ie cash surrender values) grows in value over time up to maturity value of CU100
- Assumes no lapses and no discounting

Change since 2010 ED: Presentation of interest contract revenue and expense

Our proposal: Gross performance metrics

- Present insurance contract revenue and incurred claims/expenses
- Enables results from insurance services to be compared to results of other services provided (by insurance or non-insurance companies)
- Consistent with treatment of deposits by other financial services entities

2010 proposal: Net performance metrics

- Present operating result, disaggregated into:
  - Change in contractual service margin
  - Change in risk
  - Changes in expected cash flows for current and past service
- Highlights drivers of performance. Also simpler to apply as avoids need to identify deposit component

Issue: Determining interest expense

Should companies be required to separate the results from underwriting and investment activities from the effects of the changes in discount rates?

Our proposal: Interest expense presented in profit or loss reflects a cost view

Statement of Comprehensive Income

	20XX
Operating (underwriting) result	X
Investment income	X
Interest expense (on insurance liability)	(X)
Investment result	X
Profit or loss	X
Effect of discount rate changes on insurance liability***	(X)
Total comprehensive income	XX

Profit or loss
Reflects the profit or loss from services using an amortised cost view of the time value of money**

Total comprehensive income
Reflects the profit or loss of providing services using a current view of the time value of money***

**the amortised cost view uses the discount rate determined at contract inception, and current view uses the current discount rate at reporting date

*** The 'effect of discount rate changes' reconciles the current view and the amortised cost view of performance, assuming financial assets are measured at fair value through other comprehensive income

Change since 2010 ED: Interest expense presentation in profit or loss

Our proposal

- Separates results from underwriting and investing activities from the effect of changes in discount rates in a way that aligns to proposals for financial assets at fair value through other comprehensive income.
- Two types of information provided:
  - An amortised cost-based interest expense in profit or loss
  - a current measurement balance sheet

2010 proposal

- Present the changes in the insurance contract liability arising from changes in the discount rate in **profit or loss**. This:
  - avoids reporting complexity
  - provides information about all economic gains and losses in profit or loss
  - permits greater reduction of unavoidable mismatches if fair value options are used for assets

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Issue: Applying proposals for the first time

The challenge for first-time application is measuring the contractual service margin at the date of transition.

How do we balance verifiability of the amount recognised at transition date with comparability between contracts issued prior to and after transition date?

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Applying the new accounting for the first time

Contractual service margin
(Expected contract profit)

Fulfilment cash flows

- **Future cash flows:** Expected cash flows from premiums and claims and benefits
- **Risk adjustment:** An assessment of the uncertainty about the amount of future cash flows
- **Discounting:** An adjustment that converts future cash flows into current amounts

Needs to be estimated → Estimate as if the Standard had always been applied, with simplifications that maximise the use of objective data if necessary

Can be directly measured → Measure on date of first time application

Change since 2010 ED: Applying the proposals for the first time

Our proposal

- Estimating and recognising contractual service margin on transition enables users to compare profitability of existing contracts with new contracts

2010 proposal

- Setting contractual service margin to zero and measuring liability as fulfilment cash flows would be simple, cost little and would not involve subjective information in determining the margin

Timetable

20 June 2013
Revised Exposure Draft

25 Oct 2013
Comment letter deadline

H1 2014
Board debates issues

Early 2015
Issue IFRS

Effective date
Approx 3 years after Standard finalised

For more information…

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- Visit our website:
  - www.ifrs.org
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- Sign up for our email alert

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- Email us: insurancecontracts@ifrs.org

Resources on IASB website

- IASB Update
- Project podcasts and webcasts
- Snapshot
- Feedback statement
- Investor resources
- High level summary of project

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Preliminary views on Exposure Draft and implications

Kamran Foroughi and Anthony Coughlan, Financial Reporting Group

Financial Reporting Group (FRG)

- Cross practice working group established in June 2011, with remit to:
  - consider proposed changes to financial reporting standards affecting insurers
  - support Derek Wright on the International Actuarial Association's Insurance Accounting Committee.
- Membership is made up of senior industry practitioners in the area of financial reporting, with a mixture of experience in life / non-life insurance and pensions. Also includes two chartered accountants and one sell-side equity analyst
- Additional support was sought from volunteers to help prepare the IFoA response to the IASB Exposure Draft

FRG membership:

Raymond Bennett, Daniel de Burca (Secretary), Darren Clay, Anthony Coughlan, Helena Dumcyz (IFoA), Kamran Foroughi (Chair), Gary Hibbard, Martin Lowes, Nigel Masters, Richard McPherson, Francesco Nagari, Erica Nicholson, Richard Pereira, Tony Silverman, Martin White, Derek Wright, Simon Yeung

ED response volunteers:

Rael Davis, Matthew Donnery, Vicky Flenk, Chris Knight, Richard Olswang, Vasu Patel, Michael Reid, Andrew Rowley

Many aspects of ED welcomed

- General approach principles based not rules based
- IASB’s discussion and decision making transparent
- Outreach and effort to consider feedback
- Uniform standard proposed to apply in most jurisdictions
- Proposed to minimise differences with US GAAP ED
- Margins explicitly shown
- ED based on fulfilment value not exit value concept

Improvements from 2010 ED in many areas

- Building Block Approach (BBA) closer to deferral and matching model
  - Unlocking of the Contractual Service Margin (CSM)
  - More consistent with revenue recognition proposals
- Premium Allocation Approach (PAA) no longer mandatory for short duration contracts
- Contract boundary definition changes helpful, particularly for health
- More expenses allowed in BBA
- Transitional arrangements much better
- Risk adjustment: improvements in principle, techniques and diversification allowed
- “Top-down” discount rate setting approach permitted

Significant concerns remain

- Likely lack of alignment with effective date of IFRS 9 F*inancial Instruments*
- Hybrid model: complex for preparers and hard to understand for users
- Various new proposals appear not to combine well, creating accounting volatility
- Setting the discount rate
- UK-style with profits business
- Disclosing the risk adjustment confidence interval equivalent
- Lack of thorough field testing

Overall: Cost benefit concerns, plus ability of small and medium insurers to implement

Hybrid model: complex for preparers and hard to understand for users

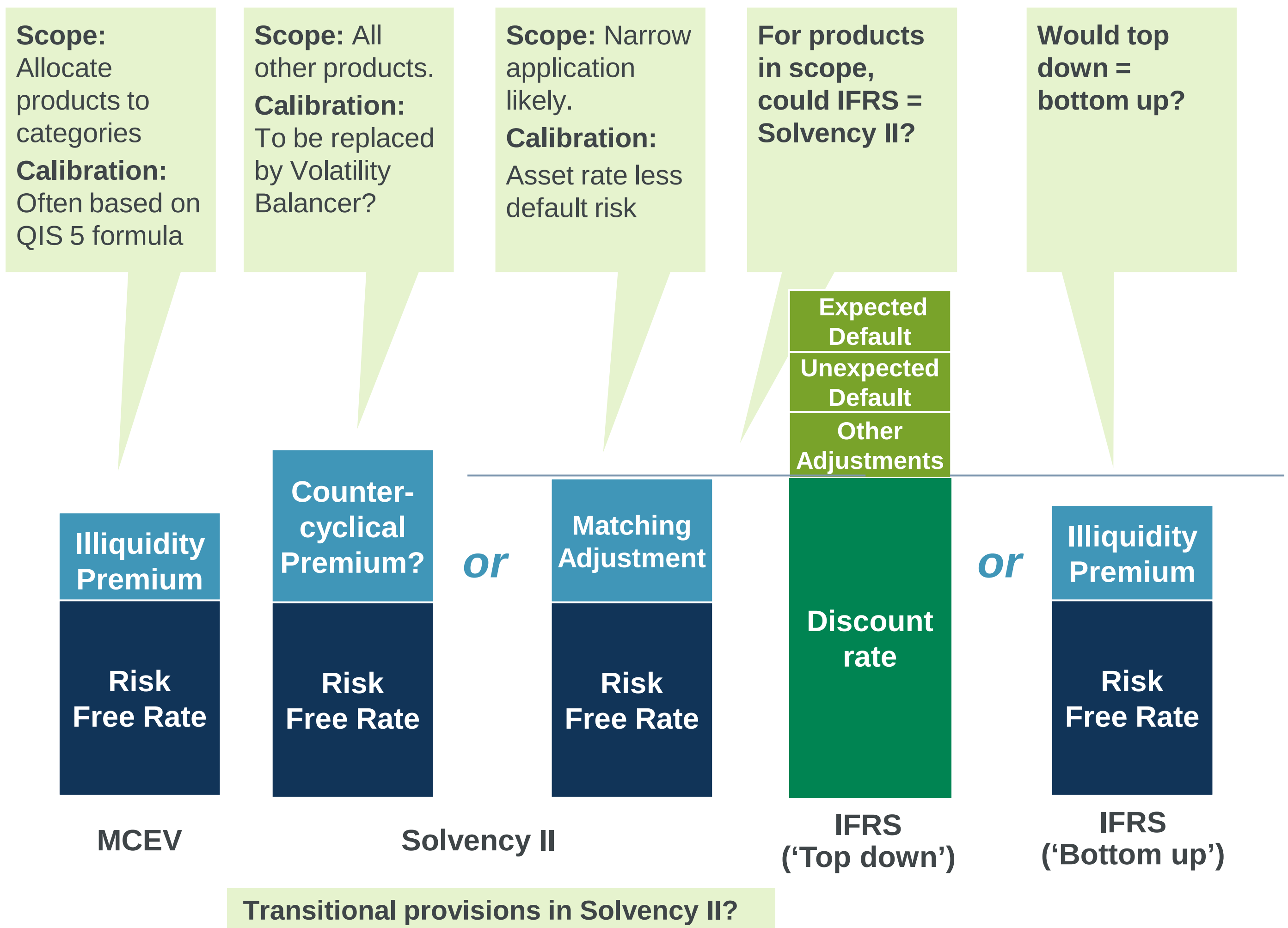
Deferral and matching | Current proposal | Economic value

- Income Statement focus
- CSM to eliminate gain at issue
- CSM now unlocked

- The current proposal has elements of both ends of the accounting spectrum
- Care must be taken in interpreting results

- Balance Sheet focus
- Expected value of cash flows using current best-estimate assumptions

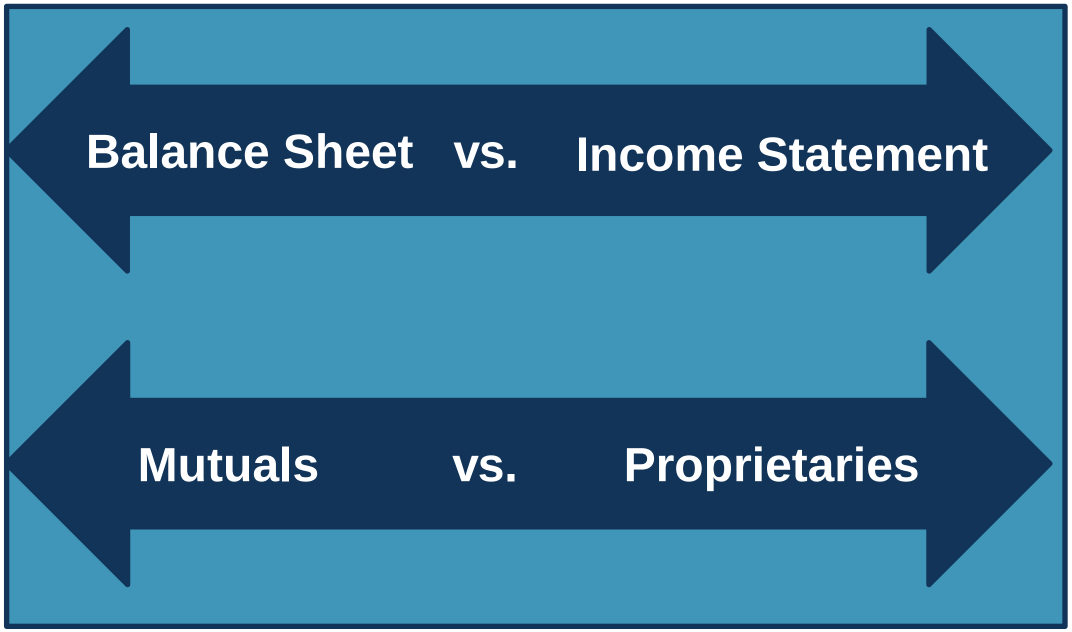
Discount rate



IFRS approach

- Reflect characteristics of cash flows: timing, currency, liquidity and linkage to returns on specific assets
- Full yield curve (historic and current) required for liabilities & CSM
- Top down "other adjustments" includes market price of liquidity for debt instruments
- Text suggests only one level of illiquidity for all cash flows.
- Interaction with investment returns?

Concerns around UK-style with-profits business



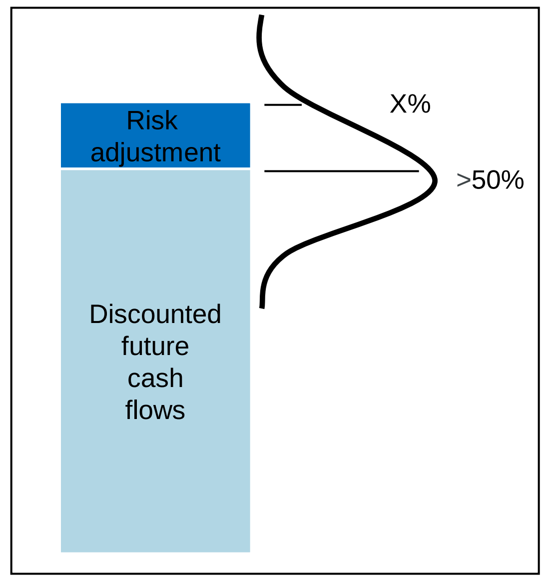
Challenge to keep all stakeholders happy!

- Proprietaries more concerned with P&L volatility
  - Will WP business exhibit more P&L volatility than unit-linked?
  - Industry “floating residual margin” proposal may partly address
- Mutuals more concerned with balance sheet capital strength
- Estate - part of liability or equity?
  - How to interpret: *“**payments arising from existing contracts** that provide policyholders with a share in the returns on underlying items..”* (ED B66k)

Requirement to disclose the confidence interval risk adjustment equivalent

Many issues with this proposal, both practical and technical, including:

- Practically it creates a lot of extra work …
  - Particularly for long term business
  - Will need to consider longer durations than currently (full term to claim settlement)
  - Companies will need to use stochastic modelling
- … without aiding comparability
  - Method never designed for purpose
  - PV fulfilment CFs perceived as calibrated to CI level
  - Gives misleading perception of comparability
  - Highly judgemental
  - Limited value when probability distribution is skewed



We proposed IFRS 7 type disclosures

Industry challenge to find suitable proposal

Lack of thorough Field Testing

- Brand new approach for companies to understand
- Current field testing of limited benefit
  - Limited take up
  - Lack of time short cuts necessary
  - Lack of clarity and understanding of ED

Critical issues may be missed!

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Focus on the 5 areas of re-exposure

ertise
onsorship
Thought leadership
Progress
Community
Sessional Meetings
Education
Working parties
Volunteering
Research
Shaping the future
Networking
Professional support
Enterprise and risk
Learned society
Opportunity
International profile
Journals
Suppor

1. Transitional Arrangements

- General changes welcomed, compared to 2010 ED nil Contractual Service Margin on transition
- Practical concerns, but be careful what you wish for !
  - May be a role for IAA
- Australia coped with similar proposals when Margin on Services became effective in 1990s
- Start capturing relevant data!

2. Insurance Contract Revenue Proposals

- Welcomed for short term /risk contracts as similar to current P&C practice
- We sympathise with idea that income statement for insurers should resemble other industries and avoid deposits treated as revenue
- However for long term business, proposals force unbundling through the back door and appear to fail decision-useful test
- FRG tentative proposals
  - Use both insurance contract revenue and sources of surplus/margin approach
  - Basis for selecting which one used needs to be practical, robust, comparable and consistent. Two suggestions:
    1. Premium Allocation Approach (PAA)-eligible contracts use earned premium/revenue, others use sources of surplus
    2. Contracts mainly insurance risk in nature use earned premium/revenue, those mainly savings / investment risk use sources of surplus

Note: 2011 IFRS working party paper contained a number of recommended enhancements to 2010 ED summarised margin approach

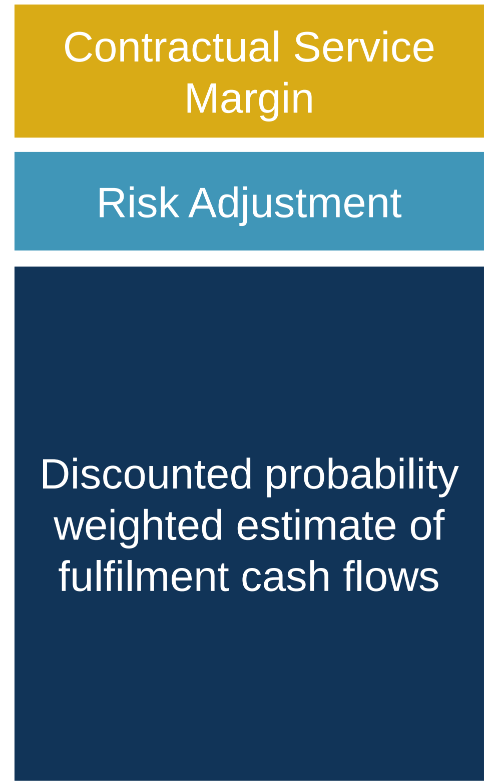
3. Other Comprehensive Income (OCI)

- Implications of ED
  - Significant change for UK insurers where using OCI for insurance liabilities is not common
  - Additional valuation runs (e.g. current and prior period rates)
  - Availability of locked in discount rate for non-life claims liability determined on an accident year basis?
  - Accounting mismatch in P&L (even where cash flows are economically matched) due to mixed asset model while mandatory presentation in OCI of changes in liabilities from changes in discount rates
- FRG tentative preferred alternative proposals
  1. P&L option – Restricted option at outset to take the impact to P&L for each portfolio of contracts
  2. Align the presentation in P&L or OCI depending on the business model – Linked to asset classification in IFRS 9
  3. Mandatory presentation in P&L – Rejected from 2010 Exposure Draft

4. Contractual Service Margin (CSM)

- Principle of unlocking welcomed, but introduces additional complexity and new issues
- Should risk adjustment changes related to future coverage go through CSM?
- Order of events (underlying profits and losses) creates asymmetric outcomes
  - Should previously recognised losses be reversed through P&L before re-establishing the CSM?
- Release of CSM
  - Release in line with “transfer of service” – how to interpret?
  - Accretion at locked-in rate causes practical issues – is accretion required or could accrete at current interest rate?
- Unit of account
  - Defined at inception at “portfolio” level and thereon not prescribed – how granular in practice?
  - Unit of account across all aspects of the model will be key in assessing the implementation requirements

Contract Liability (Building Block Approach)



5. Contracts with cash flows that vary directly with returns on underlying items

- We have sympathy with origin of "mirroring", that is a mechanism to reduce accounting mismatches
- Scope of products included in mirroring does not appear clear, for example, is UK with-profits captured by the proposal?
- Mirroring only applies where there is a requirement to hold the underlying item.
- Decomposition of cash flows into components is potentially ambiguous and onerous:

Directly varying cash flows (dependent on underlying)	→	Measured and presented with reference to the underlying item ("Mirroring")
Indirectly varying cash flows (such as options and guarantees)	→	Measured using Building Block Approach (BBA) with all changes to P&L
Other cash flows (independent of underlying items)	→	Measured using BBA and standard presentation of changes (P&L / OCI / CSM)

Combination of OCI, CSM and Mirroring

Presenting changes in insurance liabilities in either P&L, CSM or shareholder equity (OCI for discount rates) can result in unintended consequences. For example:

1. Impact of assessing changes in nominal versus real view for index linked contracts
2. Order in which each change is determined can impact:
   - Profit for the period: Due to the combination of mirroring and unlocking of the CSM
   - Shareholder equity (even when economically assets and liabilities are well matched): Due to the interaction of unlocking of the CSM and the OCI presentation for discount rate changes.
3. Changes in options & guarantees are either presented in P&L (if in the scope of mirroring) or consistently with the standard model (P&L, CSM and OCI) if not
   - Unclear why there are two approaches

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Conclusions

Conclusions

- IASB to be congratulated for publishing revised ED
- Many aspects of 2010 ED have been improved
- 2013 ED focuses consultation on 5 specific and new areas
  - Transition welcomed
  - Concerns regarding the other areas
- Other aspects of 2013 ED expected to generally remain stable

Questions

Comments

If you have any comments on this or more widely on the ED which you wish the FRG to consider in formulating its response, please raise this evening and/or email them by **Friday 20 September** to:

- Daniel de Búrca (Secretary FRG) – daniel.deburca@actuaries.org.uk
- Kamran Foroughi (Chairman FRG) – kamran.foroughi@towerswatson.com
- Derek Wright (IFoA rep IAA IAC) – dewright@deloitte.ca