Institute and Faculty of Actuaries

IFRS 4 Phase II is coming
Are you ready?

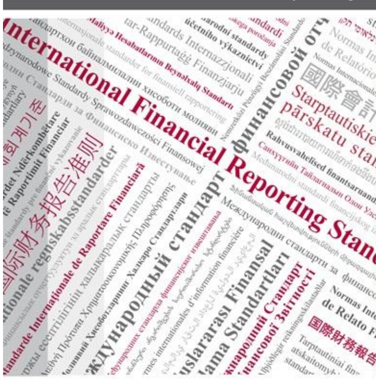
Chairman: Derek Wright

Accounting Proposals for Insurance Contracts
Guest Speaker: Izabela Ruta, IASB Insurance Contracts Project staff

Views on Exposure Draft and implications
Kamran Foroughi, Financial Reporting Group

11 November 2013

International Financial Reporting Standards



Accounting proposals for insurance contracts

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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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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

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IASB sought feedback on targeted aspects

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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

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Balancing benefits against complexity

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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

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	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

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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?

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

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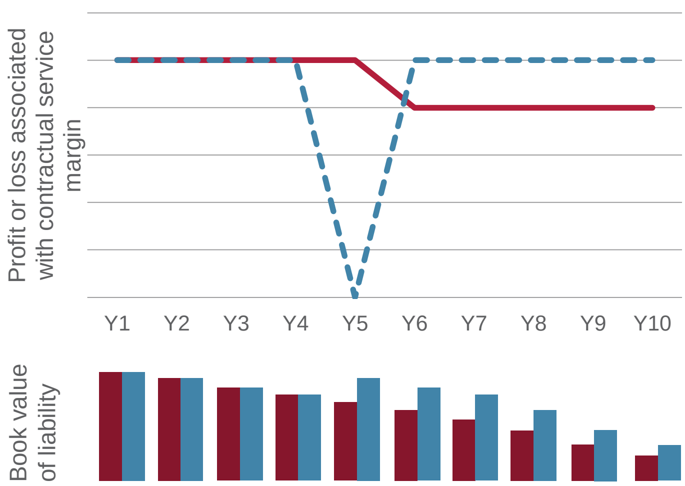

Our proposal
Adjust contractual service margin for changes in estimates of expected cash flows related to future services

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

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

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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?

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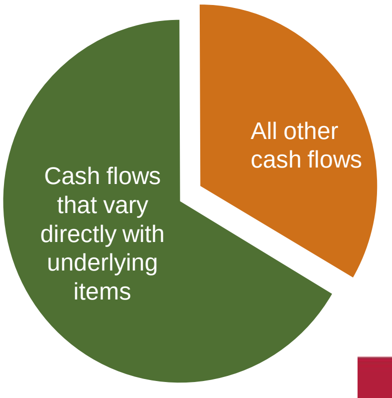
Measurement and presentation exception

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.

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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?

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

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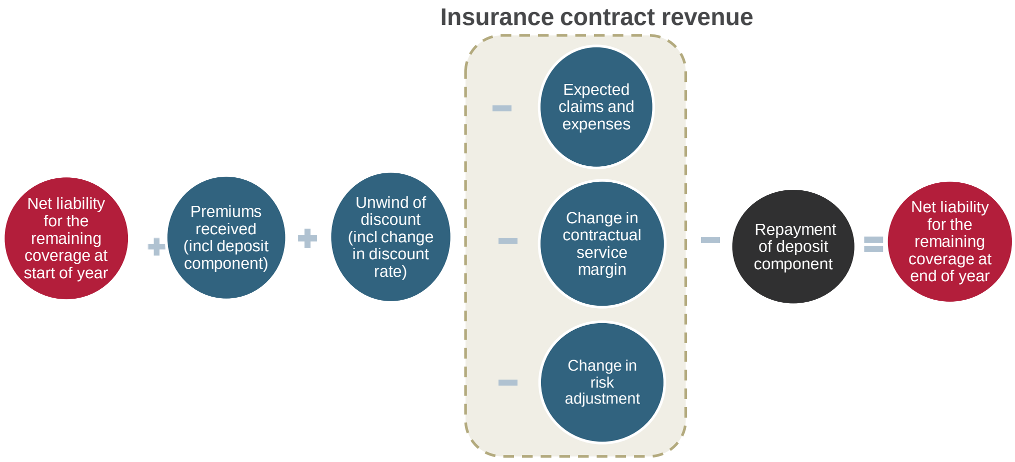

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What is revenue from insurance contracts? Level premium term life contract

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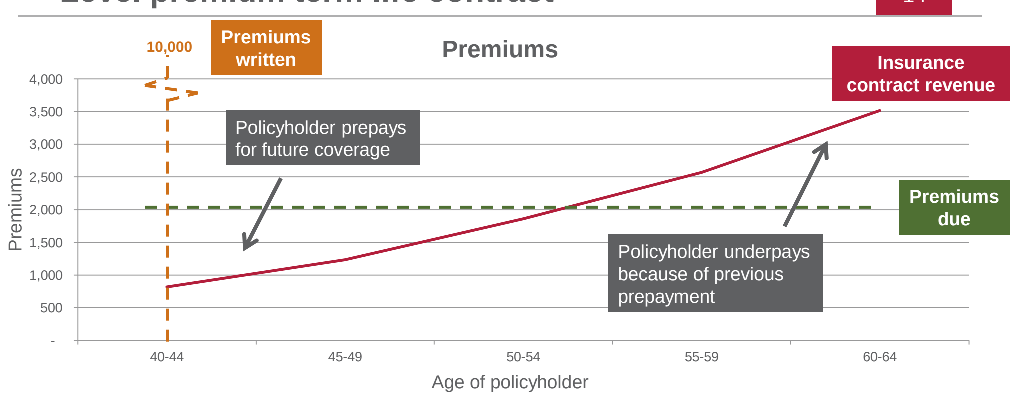

- Assumptions:
  - Portfolio of term life contracts issued to 40 year olds
  - Expected claims/benefits are 10,000; premiums are due 2,000 each 5 year period
  - Ignores premiums 'allocated' to the margins, payment of acquisition costs and payment of maintenance and benefits expense
  - Assumes no lapses,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

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

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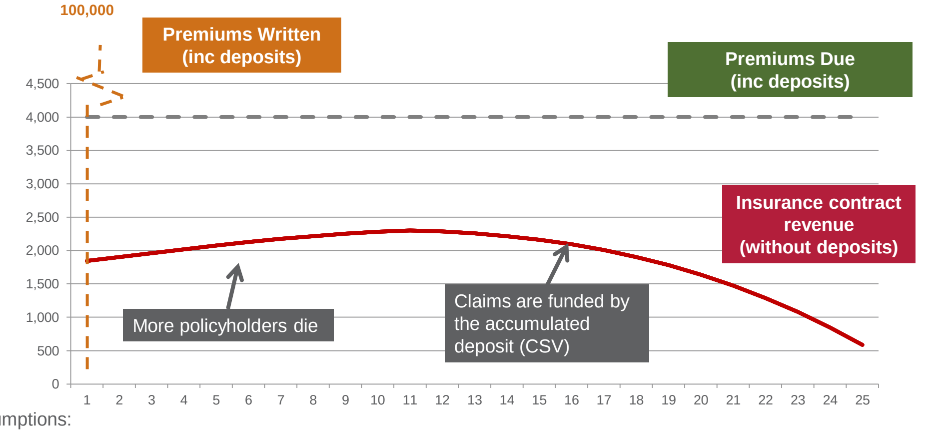

Assumptions:

- 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

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Issue: Determining interest expense

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

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

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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

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Issue: Applying proposals for the first time

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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

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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

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Timetable

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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

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Resources on IASB website

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

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Views on Exposure Draft and implications

Kamran Foroughi, 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

1. Transitional Arrangements

- Strongly support revised approach, compared to 2011 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, create much work and appear to fail decision-useful test
- FRG 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

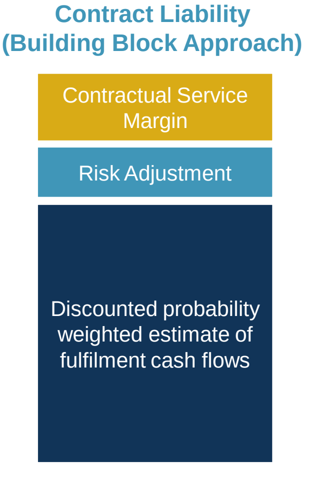
Note: 2011 IFRS working party paper contained a number of recommended enhancements to 2010 ED summarised margin approach

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?
  - 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 concerns regarding mandatory nature of OCI approach
- FRG 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

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 – align with revised OCI suggestions?
- 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



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
- Concerns around complexity of separation of cash flows into components:

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)

- Overall, we recommend mirroring is removed and BBA used instead

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

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

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.