Insurance Contracts Phase II

EFRAG Outreach

The purpose of this note is to enable EFRAG's constituents to consider the IASB's re-deliberations in relation to the Exposure Draft *Insurance Contracts* (the 'ED') before attending any of EFRAG's outreach events on the issue. At EFRAG's outreach events, constituents will be asked for their views on selected issues and any major concerns in relation to remaining issues.

On the following pages, the effects of the IASB's re-deliberations are summarised for each of these main issues. In addition, some main concerns raised by European constituents in response to the ED are summarised for each of the issues that have been re-deliberated.

This document does not address the following topics for which the IASB has not yet started redeliberations:

- Reinsurance
- Disclosure requirements;
- Transition and effective date;

General comments

Comments

- Constituents agree that a high quality standard for insurance contracts that provides a consistent basis for accounting for insurance contracts is required.
- European constituents agree with the IASB's decision to propose a comprehensive measurement approach for all types of insurance contracts.
- There is large support for many of the proposals in the ED, including the measurement based on fulfilment cash flows and the building block approach.
- However, concerns have been expressed. In particular, the interaction with other standards, the questions what constitutes the performance of an insurer and the presentation of performance in the financial statements of an insurer. Other concerns relate to the subsequent measurement of the residual margin, the summarised margin approach for presentation and the transition requirements.

Re-deliberations

- The IASB is faced with a desire and need expressed by users to issue a standard as quickly as possible because of differences in practice, but also needs to allow sufficient time for critical issues to be redeliberated. The Boards noted that quality and not timeliness should be the overriding objective of the Boards.
- The Boards tentatively confirmed that:
  - An ideal measurement model for insurance contracts would report all economic mismatches that exist and would not cause any accounting mismatches.
  - Money has a time value and an entity more faithfully represents its position when it measures its liabilities in a way that includes the time value of money.
  - The accounting model should be based on current estimates, rather than carrying forward estimates made at contract inception and inputs that are consistent with observable market data, where available.
  - The IASB noted that it has no current plans to change the classification and measurement requirements in IFRS 9.
- In June 2011, the Boards will consider whether and how to unlock the residual margin.
- The Boards or their constituents have not yet identified a clearly superior presentation format.
- The transition requirements have not been addressed yet.

Building block 1 – which cash flows

The ED

Recognition

The ED proposed that an insurer should recognise an insurance contract liability or an insurance contract asset when the insurer becomes a party to the insurance contract.

Contract boundary

The ED defines the boundary of an insurance contract as the point in time at which an insurer either:

(a) Is no longer required to provide coverage; or

(b) Has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set the price that fully reflects that risk. In assessing whether it can set a price that fully reflects the risk, an insurer should ignore restrictions that have no commercial substance.

Fulfilment cash flows

- Fulfilment cash flows constitute 'an explicit, unbiased and probability-weighted estimate (i.e. expected value) of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract.'
- In order to estimate future cash flows, an insurer should develop cash flow scenarios that reflect future events, as well as unbiased estimates of the probability-weights for each scenario. Cash flows in a scenario include all cash flows within the boundary of an existing contract that are incremental at the level of a portfolio of insurance contracts, except for acquisition costs which are considered at an individual contract level.
- Incremental cash flows for a portfolio include direct costs and systematic allocations of costs that relate directly to the insurance contracts or contract activities.

Acquisition costs

- The ED proposes that, at initial recognition, an insurer should include incremental acquisition costs in the present value of the fulfilment cash flows and recognise all other acquisition costs as an expense when incurred.
- The ED proposes that those costs should be measured at an individual contract level.

Concerns

Recognition

- The proposed point of recognition is opposed by constituents on practical grounds.

Contract boundary

- The IASB should provide more extensive application guidance.

Fulfilment cash flows

- It is believed that the definition of portfolio may be too wide when it refers to 'broadly similar risks' and 'single pool', which may lead to an imprecise level of aggregation.

- A consistent interpretation of portfolios is necessary.

Acquisition costs

- Portfolio level and not a contract level of measurement of acquisition costs is preferred.
- The term 'incremental' should be clarified as divergence in practice would otherwise arise.

Re-deliberations

Recognition

- The Boards tentatively decided:
  - To recognise insurance contract assets and liabilities when the coverage period begins.
  - Onerous contract liability to be recognised in the pre-coverage period if management becomes aware of onerous contracts in the pre-coverage period.

Contract boundary

- The Boards tentatively decided that contract renewals should be treated as a new contract:

  (a) when the insurer is no longer required to provide coverage; or

  (b) when the existing contract does not confer any substantive rights on the policyholder.

Fulfilment cash flows

- The Boards tentatively decided:

  (a) that the measurement objective of expected value refers to the mean that considers all relevant information.

  (b) To clarify that not all possible scenarios need to be identified and quantified, provided that the estimate is consistent with the measurement objective of determining the mean.

- The Boards tentatively decided:

  (a) to include all costs that the insurer will incur directly in fulfilling the contracts in that portfolio.

  (b) exclude costs that do not relate directly to the insurance contracts or contract activities, which should be recognised as expenses in the period in which they are incurred.

Acquisition costs

- The IASB tentatively decided to include in fulfilment cash flows all the directly attributable costs that the insurer will incur in acquiring a portfolio of insurance contracts.

Building block 2 – Time value of money

The ED

- The present value of the fulfilment cash flows includes a discount rate to adjust the expected value of future cash flows for the time value of money.
- The discount rate should be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability.
- The discount rate should reflect the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, with an adjustment for illiquidity
- An asset-based discount rate is used only where there is a link between the performance of specific assets and the obligation under the insurance liability.

Concerns

- Implementation guidance on the selection of the discount rate should be provided.
- Liquidity can be a characteristic of an insurance liability, but improved guidance is needed, particularly in order to avoid double counting.

Re-deliberations

- For the discount rate the Boards tentatively decided:
  - the objective of the discount rate for non-participating contracts is to adjust the future cash flows for the time value of money and to reflect the characteristics of the insurance contract liability.
  - should be a current rate that is updated each reporting period
  - not required when the effect of discounting would be immaterial.
- The Boards also tentatively decided not to prescribe a method for determining the discount rate, but the rate should:
  - be consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, including timing, currency and liquidity, but excluding the effect of the insurer's non-performance risk;
  - exclude any factors that influence the observed rates but that are not relevant to the insurance contract liability
  - reflect only the effect of risks and uncertainties that are not reflected elsewhere in the measurement of the insurance contract liability.
- The Boards agreed to include in the final standard an application guidance to clarify how a top-down approach to determine the discount rate for insurance contracts should be applied.

Building block 3 – Risk adjustment

The ED

- The ED proposed that an explicit risk adjustment is included in the measurement of an insurance liability.
- The risk adjustment is the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. The adjustment reflects estimate uncertainty.
- An insurer should estimate the risk adjustment at the level of a portfolio of insurance contracts. Therefore, the risk adjustment should not reflect the effects of diversification between portfolios of insurance contracts.
- An insurer should use only the following techniques for estimating risk adjustments: confidence level, conditional tail expectation, and cost of capital. The exposure draft outlines the main features of those methods and application guidance.
- Regardless of the method for measuring the risk adjustment, the insurer has to disclose the confidence level to which the risk adjustment corresponds.

Concerns

- The methods that can be used to measure the risk adjustment should not be limited. A principle should be developed that drives the selection of an appropriate measurement methodology.
- The confidence level to which the risk adjustment corresponds should not be disclosed.
- Diversification between portfolios should be taken into account under specific circumstances.
- As the risk adjustment is highly sensitive to the underlying inputs and methodology, the IASB should require specific disclosures in the final standard.

Re-deliberations

- The Boards tentatively decided that if there are techniques that could faithfully represent the risk inherent in insurance liabilities, the inclusion of an explicit risk adjustment would provide relevant information to users.
- The Boards tentatively decided that the objective of the risk adjustment should be the compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected.
- The Boards still need to decide whether to include explicit risk adjustment, the techniques used to measure it, the disclosures and the level of measurement (including diversification benefits).

Building block 4 – Residual margin

The ED

- The ED proposed that an insurer should not recognise any gain at inception of an insurance contract. An insurer should recognise a residual margin determined at initial recognition as income in profit or loss over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage.
- An insurer should accrete interest on the carrying amount of the residual margin.
- The ED proposed to lock-in the residual margin. The residual margin will not be recalibrated due to changes in estimates, e.g. when the discount rate changes.
- An insurer should initially determine the residual margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period.

Concerns

- Disagreement that the residual margin should be fixed at the inception of the contract. The residual margin should be adjusted to offset the changes from remeasurement of the present value of the fulfilment cash flows.
- Portfolio level of measurement as all other building blocks is preferred.

Re-deliberations

- The Boards tentatively confirmed that an insurer should not recognise any gain at inception of an insurance contract and that an insurer should recognise any loss on day one immediately when it occurs, in profit or loss (net income).
- The Boards had an educational session on remeasuring the residual/composite margin but still no decision has been reached. It is expected that the Boards will reach a decision on this issue in June 2011.
- The Boards will consider in their discussions whether to use floating margins (i.e. remeasuring the residual/composite margin for both favourable and unfavourable changes in non-financial assumptions); whether an onerous contract tests should be included; and whether only non-financial assumptions could be considered in the adjustment of the residual margin.
- The Boards will consider the level of aggregation for the residual margin at a future meeting.)

Special applications (participating features, short-duration contracts)

The ED

Participating features

The ED proposed that the new IFRS should apply to financial instruments that contain a discretionary participation feature and the liability for discretionary participation features should be measured on an expected cash flow basis.

Short-duration contracts

- The ED requires a simplified/shortcut measurement approach for certain short-term insurance contracts.
- The approach applies to contracts that have a coverage period of approximately one year or less, and that do not contain embedded options or other derivatives that significantly affect the variability of cash flows.

Concerns

Participating features

- Consistent treatment of participating features with similar features in insurance contracts.

Short-duration contracts

- Concerns as to whether the proposed approach represents a simplification over the full measurement model.
- The approach should not be a requirement but an insurer should be able to apply the full measurement model proposed in the ED to all insurance contracts.
- The approach should only be allowed for short-duration contracts with a coverage period extending to around one year.
- The pre-claims liability should not accrete interest.

Re-deliberations

Participating features

- The IASB tentatively decided:
  - the objective of the discount rate used to measure participating insurance contracts should be consistent with the discount rate used to measure non-participating insurance contracts.
  - provide guidance that to the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the performance of specific assets, the insurer should adjust those cash flows using a discount rate that reflects that dependence.
- The IASB need to further decide on the measurement of participating contracts (cash flows)

Short-duration contracts

- The IASB has discussed various issues (eligibility requirements, appropriate measurement during the preclaims period, etc.) but will consider the issue at a future meeting.
- The presentation for short-duration contracts will be considered when presentation is discussed.

Definition, Scope and Unbundling

The ED

Definition

The definition and scope proposals in the ED are similar to current provisions of IFRS 4. There are however two changes in the definition:

a. In addition, a contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums.

b. The insurer takes into account the effect of the time value of money in determining whether it will pay significant additional benefits.

Scope

- The ED proposes that all financial guarantees that meet the definition of an insurance contract should be treated as an insurance contract.
- Fixed-fee service contracts that have as their primary purpose the provision of services, but expose the service provider to risk because the level of service depends *on an uncertain event, are excluded from the scope of the ED.*

Unbundling

The ED proposed that components of an insurance contract should be unbundled (recognised and measured separately) if these components are not closely related to the insurance coverage.

Concerns

Definition

The definition of an insurance contract as currently included in IFRS 4 has worked well in practice, and the changes in the definition may cause certain contracts to be excluded.

Scope

- The criteria for exclusion of fixed fee contracts from the scope of the standard are not clear enough.
- There are practicability concerns regarding the application of the insurance contracts proposals to all ‘financial guarantee contracts’ and it is better to retain the current option in IAS 39 which has worked well in practice.

Unbundling

- The term ‘closely related’ is not clearly defined.
- The underlying principle should be further clarified as unbundling can appear contradictory to the decision in the proposals not to split insurance contracts into different components.

Re-deliberations

Definition

The IASB has reconfirmed the proposed definition in the ED, together with the additional guidance.

Scope

- The IASB has reconfirmed its position in the ED to exclude from the scope of the insurance contracts standard some fixed–fee service contracts which have as their primary purpose the provision of services but still needs to decide on how to identify such contracts.
- The IASB tentatively decided that financial guarantee contracts (as defined in IFRSs) would not be in the scope of the insurance contracts standard as proposed in the ED. Instead:
  - (a) an issuer of a financial guarantee contract (as defined in IFRSs) is permitted to account for the contract as an insurance contract if the issuer had previously asserted that it regards such contracts as insurance contracts; and
  - (b) an issuer of a financial guarantee contract (as defined in IFRSs) is required to account for the contract as a financial instrument in accordance with the financial instruments standards in all other cases.

Unbundling

- The IASB tentatively decided that an insurer should account separately for embedded derivatives that are contained in a host insurance contract that is not closely related to the embedded derivative.
- The IASB still needs to decide whether to unbundle goods and services and account balances and unit-linked contracts and how to allocate expenses to unbundled components.

Presentation

The ED

- The ED proposed that an insurance contract should be presented in the financial statements using a 'summarised margin' approach. This approach reflects all cash inflows associated with an insurance contract as deposits received from its policyholders and all the cash outflows as repayments to policyholders. It does not present any items of income or expense relating directly to those cash flows.
- On the statement of financial position, an insurer should present each insurance contract as a single item within insurance contract assets or insurance contract liabilities. Liabilities arising from unit-linked contracts and the underlying assets should be presented as separate line items.
- Deferred acquisition cost assets will not be reported in the statement of financial position as these costs will either be expensed or form part of the cash flow estimate of the insurance liability.

Concerns

- Volume information, such as premiums written, claims expenses, and claims handling expenses is considered useful information and should be presented on the face of the statement of comprehensive income for all insurance contracts together with the underwriting margins.
- Certain changes in estimates should be offset against the residual margin.
- Not all income and expenses arising from insurance contracts should be reported in profit or loss. It may be appropriate to report some income or expenses in OCI.

Re-deliberations

The IASB had educational sessions on alternative presentation models. The IASB has consulted the IASB Insurance Working Group on their preferred presentation model and whether some changes in the insurance liability can be presented in OCI. The following issues still remain open for the IASB to consider and decide:

- Whether and how to expand the summarised margin approach
- Whether and how to disaggregate changes in the liability
- Where (ie within profit and loss, or in other comprehensive income) any disaggregated components should be presented.

The volatility issue

The ED

The measurement model proposed in the ED leads to volatility, which is considered by constituents to not faithfully represent the underlying economic phenomena.

Concerns

- Volatility that would arise under the proposed model still remains a critical issue for constituents.
- The Board has not sufficiently considered the interaction between the proposals in the ED and other standards, which require application of different measurement models to the assets and liabilities of an insurer. This gives rise to accounting mismatches, particularly when an insurer measures some of its assets at amortised cost in accordance with IFRS 9.
- The IASB has not sufficiently explored issues around what constitutes the performance of an insurer and how this should be presented in the financial statements.

Re-deliberations

- Although the primary objective of the Boards in the insurance contracts phase II project is not to minimise volatility, the Boards have considered throughout their discussions so far whether any reported volatility is a faithful representation of the underlying economic phenomena.
- The five areas that have an impact upon the volatility as reported and which the Boards have considered or will consider are:
  - (a) Selection of the discount rate – The Boards tentatively decided not to prescribe a single method for determining the discount rate.
  - (b) Locking in the discount rate at inception – The Boards tentatively confirmed that the discount rate used to measure all insurance contracts should be a current rate
  - (c) Presentation (e.g. by presenting the effects of volatility separately, or by defining a measure of 'operating profit' for insurers). The Boards have not reached a decision so far.
  - (d) Unlocking the residual margin – The IASB Staff is currently discussing with users whether the residual margin should be unlocked and, if so, how this should be done.
  - (e) Unbundling – Unbundling, which could allow investment components to be measured at amortised cost, has not yet been considered by the Board.