International Financial Reporting Standards

Insurance Contracts Standard

Initial measurement of insurance contracts

Darrel Scott

IASB member

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

IFRS™

Topics

1. The need for change and the history of the project
2. What is an insurance contract?
3. Initial measurement of insurance contracts
4. Subsequent measurement of insurance contracts
5. Modifications to General model: variable fee contracts
6. Other modifications to the General model
7. Presentation and disclosure
8. Applying the standard for the first time

IFRS™

Measure contract at initial recognition
Future cash flows

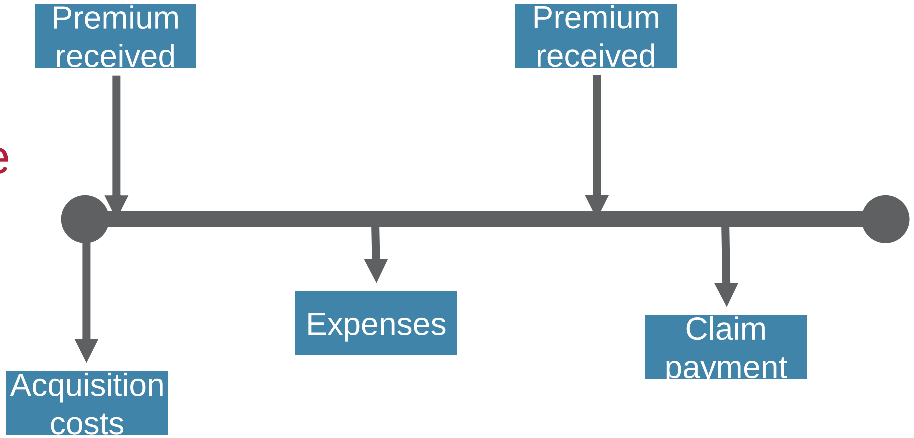
Measurement of an insurance contract incorporates all available information, in a way consistent with observable market information.

Future cash flows
expected cash flows from premiums, claims and benefits

An explicit, unbiased and probability-weighted estimate of future cash flows that will arise as the insurer fulfils the insurance contract

Measure contract at initial recognition
Future cash flows

Recognition:
Contract starts when coverage period begins (may be after insurer is on risk) unless contract is onerous



Included in cash flows:
All direct costs of *originating* and all directly attributable costs incurred in *fulfilling* insurance contracts

Contract boundary:
Contract ends when:
- Not required to provide coverage
- Can reprice to reflect risks of policyholder
- Or, In some cases, to reflect risk of portfolio
- On substantial modification

IFRS™

Measure contract at initial recognition
Future cash flows: mutualisation

In some contracts or contract types, other policyholders form first layer of risk absorption. In such cases:

- Expected cash flows from/to participating policyholders are part of the fulfilment cash flows of the primary policyholders: A group of policies is not considered to be onerous if another set of policyholders bears those losses
- Losses are only recognised in profit or loss from onerous contracts when the underlying items in the fund as a whole are insufficient to bear those losses, ie when no other policyholder has the capacity to absorb those losses

Example
Future cash flows: mutualisation

- Insurer issues 5 year motor insurance contracts, which compensate policyholders for theft and accidents
- Insurer also issues 5 year participating contracts, with a payout subject to profitability of the motor book – **if** motor book performs:
  - As expected, par contracts pay a market return;
  - Better then expected, extra return paid to par contracts
  - Worse then expected, shortfall deducted from par return
- In determining cash flows of the motor book, the insurer should consider the net cash flows (after participation)

IFRS™

Measure contract at initial recognition
Discounting

Measurement of an insurance contract incorporates all available information, in a way consistent with observable market information.

Future cash flows

Discounting
adjustment that converts future cash flows into current amounts

Measure contract at initial recognition
Discounting

- Discount rate should reflect the characteristics of the liability cash flows
- Discount rate should be consistent with observable market for instruments with cash flows with consistent characteristics
- Operationally, entity can use either:
  – A bottom up approach, or
  – A top down approach

Measure contract at initial recognition
Discounting: unobservable rates

- *Discount rate should be consistent with observable market for instruments with cash flows with consistent characteristics*
- Use judgement to:
    - Appropriately adjust observable inputs to accommodate differences between observable market and insurance contract cash flows
    - Develop unobservable inputs using best information available consistent with the objective (unobservable inputs should not contradict available and relevant market data).

Measure contract at initial recognition
Risk Adjustment

Measurement of an insurance contract incorporates all available information, in a way consistent with observable market information.

Future cash flows

Discounting

Risk adjustment
assessment of uncertainty about future cash flows and cost to entity

Measure contract at initial recognition
Risk Adjustment

- The compensation the entity requires for bearing the uncertainty
- Compensation that makes entity indifferent between:
  - fulfilling liability that has range of possible outcomes; and
  - fulfilling liability that will generate fixed cash flows with the same expected present value
- Entity specific measure:
  - The entity’s level of risk aversion
  - The degree of diversification benefit the entity considers in determining required compensation

Measure contract at initial recognition
Fulfilment cash flows

Measurement of an insurance contract incorporates all available information, in a way consistent with observable market information.

'Fulfilment cash flows'

Future cash flows

Discounting

Risk adjustment

Fulfilment cash flows is a probability-weighted estimate of cash inflows and outflows that will arise as the entity fulfils the contract.

IFRS™

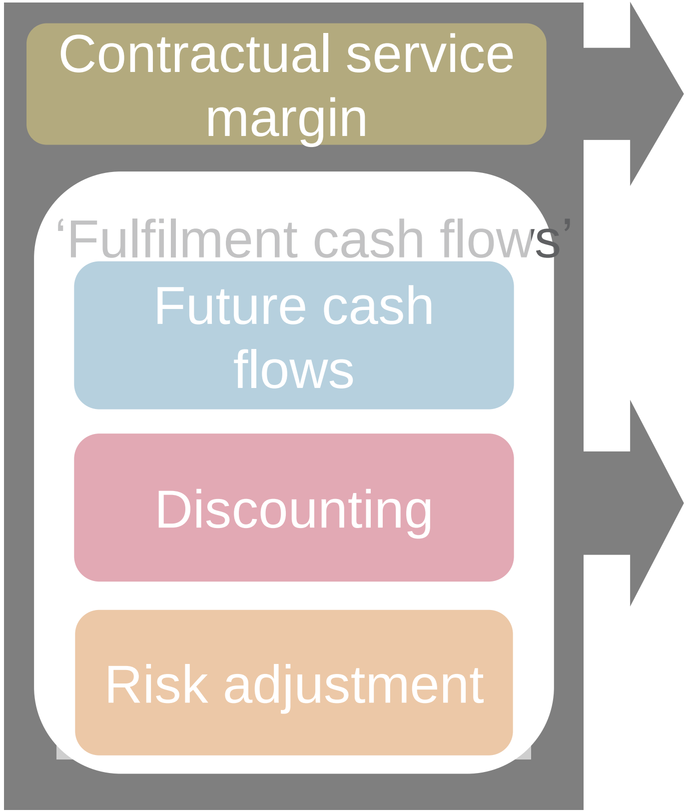
Measure contract at initial recognition
Fulfilment cash flows: Level of aggregation

Level of aggregation is **not** relevant for:

- Determination of fulfilment cash flows
    - Present value is consistently applied irrespective of level of application
- Determination and allocation of directly attributable expenses
    - Allocation based on nature and ‘attribute-ability’ of costs
- Determination and allocation of risk margin
    - Based on entity approach to determining compensation for risk

Measure contract at initial recognition
Contractual Service Margin (CSM)

Measurement of an insurance contract incorporates all available information, in a way consistent with observable market information.



Contractual service margin is measured as the **positive** (net inflow) difference between the risk-adjusted present value of expected inflows and outflows at inception.

Fulfilment cash flows is a probability-weighted estimate of cash inflows and outflows that will arise as the entity fulfils the contract.

Measure contract at initial recognition
CSM

- CSM is determined as the risk adjusted present value of the cash inflows and outflows
- As such, at inception it captures the expected profitability of the contract over its entire expected life
  - If expected to be loss making, CSM is ‘negative’ and recognised in profit or loss (<u>onerous contract</u>)
  - If expected to be profit making, CSM is ‘positive’ and recognised as a liability (<u>unearned profit</u>)
- At inception, CSM is <u>not</u> a cash flow, instead it is the inverse of other cash flows

IFRS™

Measure contract at initial recognition
CSM: Level of aggregation?

- In some circumstances, CSM gains are treated differently from losses (onerous contracts)
- May create a different accounting outcome depending on level of aggregation
- Need to specify level of aggregation for determining onerous contracts
- Balance between loss of information about individual contracts and providing a faithful representation of the effect of grouping contracts

Measure contract at initial recognition
CSM: Onerous contracts

- Loss for onerous contracts should be recognised only when the contractual service margin is negative for a group of contracts, and that group should comprise contracts that at inception have:
  - Cash flows entity expects will respond in similar ways to key drivers of risk in terms of amount and timing AND
  - Similar expected profitability (ie similar contractual service margin as a percentage of the premium)
- Within group, net off the negative and positive CSM
- Group not reassessed after inception

IFRS™

Measure contract at initial recognition
CSM: Effect of regulation

- No exception to the level of aggregation for determining onerous contracts or the allocation of the contractual service margin when regulation affects the pricing of contracts
    - Contracts that do not have similar profitability, even if as a consequence of regulation, may not be aggregated for determining onerous contracts

Measure contract at initial recognition
Contractual Service Margin (CSM)

Measurement of an insurance contract incorporates all available information, in a way consistent with observable market information.

Contractual service margin

'Fulfilment cash flows'

Future cash flows

Discounting

Risk adjustment

Contractual service margin is measured as the **positive** (net inflow) difference between the risk-adjusted present value of expected inflows and outflows at inception.

Fulfilment cash flows is a probability-weighted estimate of cash inflows and outflows that will arise as the entity fulfils the contract.

IFRS™

Thank You


individual comments
questions
expressions of individual views
comments
expressions of
individual views
feedback
questions
feedback
questions or comments
expressions of individual views
comments
dividual comments
questions or
ndividual
comments
expressions of
question
expressions of individual vie
expressions of individual views
essions and viewpoints