STAFF PAPER

March 2014

REG IASB Meeting

Project	**Insurance contracts**
Paper topic	Cover note

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Purpose of paper

1. This paper:

    (a) Provides an overview of the papers for the March meeting, together with a summary of the staff recommendations (paragraphs 2-8).

    (b) Provides a reminder of the background for the IASB's project on insurance contracts (paragraphs 9-14).

    (c) Provides an overview of the accounting model proposed by the IASB's 2013 Exposure Draft *Insurance Contracts* ('the 2013 ED') (paragraphs 15-22).

    (d) Summarises project progress and next steps (paragraphs 24-25).

Papers for this meeting

2. The agenda papers for this meeting consider two of targeted proposals in the 2013 ED. Both these issues deal with how entities account for changes in estimates. The agenda papers consider only insurance contracts that have no participating features. Participating features in insurance contracts provide policyholders with explicit investment returns (for example, Universal Life, Unit-linked, etc). Issues specific to participating contracts will be considered at a later stage, and, at that stage, the staff will consider whether the tentative decisions reached for non-participating contracts need to be revisited.

Unlocking the contractual service margin

3. Agenda papers 2A-2C discuss the proposals subject to Question 1 of the 2013 ED to recognise the effect of changes in estimates of future cash flows relating to future service when the service is delivered (ie unlocking the contractual service margin).

4. These proposals were widely supported in the response to the 2013 ED. However, many constituents think that the proposals should be refined by extending the proposals to cover the effect of changes in estimates of risk adjustment relating to future service. Similar views were expressed by members of the Accounting Standards Advisory Forum (ASAF) at their meeting on 3 March 2014.

5. The papers and recommendations are as follows:

   (a) Agenda paper 2A *Unlocking the contractual service margin* recommends that the IASB confirm the proposals in the IASB ED that after inception:

      (i) differences between the current and previous estimates of the present value of cash flows related to future coverage and other future services should be added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

      (ii) differences between the current and previous estimates of the present value of cash flows that do not relate to future coverage and other future services should be recognised immediately in profit or loss.

   (b) Agenda paper 2B *How to unlock the contractual service margin—treatment of previously recognised losses* recommends that favourable changes in estimates that arise after losses were previously recognised in profit or loss should be recognised in profit or loss to the extent that they reverse those losses.

   (c) Agenda paper 2C *Whether to unlock the contractual service margin for changes in the risk adjustment* recommends that differences in the current and previous estimates of the risk adjustment that relate to coverage and other services for future periods should adjust the contractual service margin subject to the condition that the margin should not be negative. Consequently, changes in the risk adjustment that relate to the coverage and others services provided in the current and past periods should be recognised in profit or loss.

Presenting the effect of changes in discount rate in other comprehensive income

6. Agenda papers 2D-2F discuss the proposal subject to Question 4 of the 2013 ED to recognise the effects of changes in the discount rate since inception in other comprehensive income ('OCI').

7. Most constituents welcomed the IASB's decision that entities could present the effects of changes in discount rate in OCI. However, they commented that mandatory presentation of the effect of changes in discount rates would cause extensive accounting mismatches, because of the mixed measurement attribute model for the assets the entity would hold to back the insurance contracts. Accordingly, they suggest allowing an option so that entities could present such changes in profit or loss. Similar views were expressed by members of the ASAF at their meeting on 3 March 2014. Some opposed the proposals because the requirement to use locked-in discount rates would be onerous.

8. The papers and recommendations are as follows:

   (a) Agenda paper 2D *Use of OCI to present the effect of changes in discount rates* recommends that the IASB confirm the use of OCI as proposed in the 2013 ED, subject to:

      (i) Developing an option that would permit entities to present the effect of changes in discount rates on the measurement of insurance contracts in P&L or OCI; and

      (ii) Developing disclosures that provide information about the effect of changes in discount rate during the period.

   (b) Agenda paper 2E *An option for presenting the effect of changes in discount rates* recommends that an entity should choose to present the effect of changes in discount rates in P&L or in OCI as its accounting policy and should apply that accounting policy to all contracts within a portfolio.

(c) Agenda paper 2F *Disclosure of the effect of changes in discount rates* recommends that entities disclose the following information:

(i) *For all portfolios of insurance contracts:* Disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum into:

1. the amount of interest accretion determined using current discount rates,
2. the effect on the measurement of the insurance contract of changes in discount rates in the period, and
3. the difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period measured using discount rates that applied on initial recognition of insurance contracts, and when measured at current rates.

(ii) *In addition, for portfolios of insurance contracts for which the effect of changes in discount rates are presented in other comprehensive income:* Disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum into:

1. interest accretion at the discount rate that applied at initial recognition of insurance contracts reported in P&L for the period; and
2. the movement in OCI for the period.

Background for the IASB's project on insurance contracts

Objectives

9. At present, IFRS has no comprehensive standard that deals with the accounting for insurance contracts. IFRS 4, published in 2004, is an interim Standard that provides disclosures, but permits a wide range of practices and includes a

'temporary exemption', which explicitly states that an entity does not need to ensure that its accounting policies are relevant to the economic decision-making needs of users of financial statements, or that those accounting policies are reliable. This means that:

(a) entities account for insurance contracts using different accounting models that evolved in each jurisdiction according to the products and regulations prevalent in that jurisdiction, and

(b) users of financial statements are not provided with all the information they need to understand the financial statements of entities that issue insurance contracts, or to make meaningful comparisons between entities.

10. The IASB's proposals are intended to improve financial reporting by providing more transparent, comparable information about:

(a) the effect of the insurance contracts an entity issues on the entity's financial performance;

(b) the way an entity makes profits or loss through underwriting risks and investing premiums from customers; and

(c) the nature and extent of risks that an entity is exposed to as a result of issuing insurance contracts.

Building on previous consultation

11. The 2013 ED builds on the proposals previously set out in:

(a) the Discussion Paper *Preliminary Views on Insurance Contracts*, published in May 2007, which explained the IASB's initial views on insurance contracts; and

(b) the Exposure Draft *Insurance Contracts* (the '2010 ED'), published in July 2010, which developed those initial views into a draft Standard.

12. The feedback received on the IASB's earlier documents confirmed that there was widespread acceptance that the proposed approach to measure insurance contracts using a current, market-consistent approach (see paragraphs 15-22). That

feedback indicated that many agree that such an approach would provide financial information that is relevant to users of the financial statements of entities that issue insurance contracts, and would faithfully represent the financial position and performance of such entities. As a result of this previous work, the IASB was satisfied that its measurement model for insurance contracts is appropriate and would result in improvements to financial reporting.

13. However, the IASB made some significant changes to its 2010 proposals, in response to issues identified in previous consultations. The IASB believes that those changes would result in a more faithful representation and more relevant and timely information about insurance contracts compared to the proposals in the 2010 ED. However, these proposals are more complex to apply than the proposals in the 2010 ED. Accordingly, while the 2013 ED contained a complete draft of the proposed Standard on insurance contracts so that interested parties could consider the proposals in context, the IASB sought input only on the following five areas:

    (a) Refinements to the measurement approach to propose:

        (i) That an entity should recognise any change in estimates relating to future service in the period in which the service is provided (ie to 'unlock' the contractual service margin); and

        (ii) A measurement and presentation exception to reflect situations in which there can be no economic mismatches between the insurance contract and assets backing that contract.

    (b) Development of the presentation approach to propose that an entity should:

        (i) Align the presentation of revenue with that required for other contracts with customers by other IFRSs; and

        (ii) Present interest expense from insurance contracts in a way that enables an amortised cost-based expense to be presented in profit or loss and a current-value-based balance sheet to be presented.

(c) Amendments to the transition approach to propose simplifications that maximise the use of objective data and to improve comparability for contracts originated before and after application of the proposals.

14. The IASB also sought input on whether the costs of the revised information are justified by the benefits of the information provided overall. However, in publishing the 2013 ED, the IASB stated its intent that it would not revisit issues that it has previously rejected or reconsider consequences it has previously considered.

The accounting model proposed by the IASB

15. The 2013 ED proposes that an entity should measure insurance contracts using a current value approach that incorporates all of the available information in a way that is consistent with observable market information. As a result, the IASB has tentatively decided that the measurement of an insurance contract should incorporate a current, unbiased estimate of the cash flows expected to fulfill the liability, reflect the time value of money, risk and uncertainty and be calibrated at inception to the premium (except when onerous).

16. In addition, the 2013 ED proposed a presentation approach that would reflect (a) underwriting experience, the change in uncertainty and the profit from services in the period and, (b) through the interest and discount rate changes, both a current and a cost-based view of the cost of financing the insurance contract.

17. The IASB believes that the use of a current value measurement model for the insurance contracts liability is desirable for three important reasons:

(a) It provides transparent reporting of changes in the insurance contract liability, including changes in the economic value of options and guarantees embedded in insurance contracts.

(b) It provides complete information about changes in estimates.

(c) It means that the assets and liabilities of an entity can be measured on a consistent basis[1], thus reducing accounting mismatch in comprehensive income and equity.

18. However, in a current measurement model, reported volatility can arise if there are economic or accounting mismatches. In other words, volatility arises:

(a) if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. Such **economic** mismatches may result in reported volatility which the IASB believes faithfully represents the underlying economics.

(b) if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes because they are measured on different bases. The IASB seeks to eliminate such **accounting mismatches.**

19. When an entity has an economic mismatch, market fluctuations give rise to real economic effects. When combined with a current measurement of the assets, a current measurement of the liability portrays those effects. Such economic mismatches include:

(a) Changes in expected credit losses on assets if those credit losses do not affect the amounts payable to policyholders.

(b) Changes in the risk premium that investors charge for bearing the risk that credit losses might exceed expectations if those credit losses do not affect the amounts payable to policyholders.

(c) Changes in the premium that investors pay (by receiving a reduced return) to invest in assets that provide liquidity, if the amounts paid to policyholders do not include a similar reduction because the liabilities do not provide similar liquidity for policyholders.

(d) Duration mismatches between assets and liabilities.

[1] Ie assuming that assets are measured at fair value

(e) Any guarantees written by the entity, for example a requirement that the entity will pay policyholders the higher of a return based on actual asset returns and a specified minimum return.

20. Furthermore, we believe that volatility in itself is not undesirable as long as the source of volatility can be understood and clearly related to economic phenomena. However, volatility that arises only from accounting mismatch does not provide a faithful representation of the underlying economic phenomena.

21. The extent of reported volatility arising from a current value approach was a critical issue in the feedback to the 2010 ED. The proposals in the 2013 ED would reduce the extent of reported volatility as follows:

(a) The IASB confirmed that both a top-down and a bottom-up approach can achieve the objective of the discount rate and that the entity can decide which approach is best in its circumstances. The top-down approach significantly reduces accounting mismatch arising from the effect of credit spread changes by reflecting the effect of credit spread changes in both the asset and liability measurement.

(b) The IASB decided to adjust (ie ‘unlock’) the contractual service margin for differences between current and previous estimates of cash flows relating to future coverage or other future services. This means that effect of changes in estimates of cash flows would be reported over the remaining coverage period, rather in the period of change.

(c) The IASB decided to present the changes in the insurance contract liability arising from changes in the discount rate in OCI, rather than in profit or loss.

(d) The IASB decided that, for contracts which create a contractual link between the underlying items and the insurance contract liabilities, the measurement and presentation of the liabilities should mirror the measurement and presentation of the assets. Consequently, volatility arising from accounting mismatch is reduced for such contracts.

22. As a consequence of these decisions, there is additional complexity in understanding how changes in estimates are treated under the model. The following table summarises the treatment of changes in estimates.

Type of change in estimate	Where recognised
Change in present value of cash flows relating to future service	Adjust contractual service margin, and recognised in profit or loss when future service provided
Change in present value of cash flows relating to past and current periods' service (ie experience adjustments)	In profit or loss in the period of change (underwriting result)
Change in present value of cash flows unrelated to service (eg some deposits)	In profit or loss in the period of change (net interest and investment)
Unwinding of discount based on discount rate at inception	In profit or loss in period of unwind (net interest and investment)
Effect of changes in discount rates on the measurement of liability	In other comprehensive income in the period of change
Changes in the risk adjustment (relating to current, past and future service)	In profit or loss in the period of change

23. Nonetheless, volatility from economic mismatches remains an important issue in the feedback on the 2013 ED, particularly for participating contracts.

Project progress and next steps

24. In January 2014, the IASB discussed summaries of the feedback from comment letters, outreach (including with users of financial statements) and fieldwork on the 2013 ED. No decisions were made.

25. This meeting marks the start of redeliberations, with decisions sought on the main issues for two of the five areas targeted in the 2013 ED. At the April meeting, the staff intends to ask the IASB to consider the main issue relating to insurance contracts revenue, and to consider the approach to other issues raised in the response to the ED that were not targeted for input. The IASB expects that redeliberations of its proposals for the accounting for insurance contracts will be

completed in 2014, with the publication of a final Standard following in 2015. A more exact timetable will be dependent on decisions the IASB takes in April 2014.