IFRS

# STAFF PAPER

October 2014

## REG IASB Meeting

| Project | Insurance Contracts | | |
|---|---|---|---|
| Paper topic | Cover note | | |
| CONTACT(S) | Andrea Pryde | apryde@ifrs.org | +44 (0)20 7246 6491 |
| | Milena Lacheta | mlacheta@ifrs.org | +44 (0)20 7246 6494 |

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

1. This cover note provides an overview of progress on the Insurance Contracts project and provides:
   (a) an overview of the accounting model proposed by the IASB (Appendix A);
   (b) A summary of the IASB's tentative decisions on contracts with no participating features (Appendix B); and
   (c) A summary of the approach taken by the IASB in developing the proposals for contracts with participating features (Appendix C).

## Papers for this meeting

2. There is one Agenda Paper for this meeting, which discusses transition for contracts with no participating features. The staff are not aware of any aspects of the accounting for contracts with participating features that need to be considered in transition. However, the staff will review the transition requirements for contracts with participating features when we have finalised the model for contracts with participating features.

3. In Agenda Paper 2A *Transition* the staff recommend that the IASB should confirm the proposal in 2013 ED that at the beginning of the earliest period presented, an entity should:

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

(a) apply the Standard retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* unless impracticable; and

(b) if retrospective application of the Standard is impracticable, an entity should use the simplified approach proposed in paragraphs C5 and C6 of the 2013 ED with the following modification: instead of estimating the risk adjustment at the date of initial recognition as the risk adjustment at the beginning of the earliest period presented, an entity should estimate the risk adjustment at the date of initial recognition by adjusting the risk adjustment at the beginning of the earliest period presented by the expected release of the risk before the beginning of the earliest period presented. The expected release of risk should be determined by reference to release of risk for similar insurance contracts that the entity issues at the beginning of the earliest period presented.

(c) if the simplified approach described in paragraph (b) is impracticable, an entity should apply a 'fair value approach' in which the entity should:

(i) determine the contractual service margin at the beginning of the earliest period presented as the difference between the fair value of the insurance contract at that date and the fulfilment cash flows measured at that date; and

(ii) determine interest expense in profit or loss, and the related amount of other comprehensive income accumulated in equity, by estimating the discount rate at the date of initial recognition using the method in the simplified approach proposed in paragraph C6(c) and (d) the 2013 ED.

4. The staff also recommend that, for each period presented for which there are contracts that were measured in accordance with the simplified approach in paragraph 3(b) or the fair value approach in paragraph 3(c), an entity should disclose the information proposed in paragraph C8 of the 2013 ED separately for:

(a) contracts measured using the simplified approach; and

(b) contracts measured using the fair value approach.

### *Project progress*

5. The IASB is nearing the end of a long and thorough due process on its proposals to develop for insurance contracts. In doing so, the IASB has sought to balance many diverse views and develop an approach that provides useful financial information that can be applied in all jurisdictions that apply IFRS.

6. Since January 2014, the IASB has been deliberating issues raised in the third consultation round. So far, the IASB has completed its discussions on the model for insurance contracts with no participating features. Appendix B summarises the IASB's tentative decisions to date.

#### *Next steps*

7. In recent IASB meetings, the IASB has explored aspects of the model for insurance contracts with participating features. The staff's approach for contracts with participating features is to consider the adaptations that would be needed if the general proposals in the 2013 ED were to be applied to contracts with participating features. Appendix C provides further detail on this approach, and describes the IASB's directions to staff to date.

8. The staff expect to continue discussions on contracts with participating features during the second half of 2014. In November 2014, the IASB will hold an education session in which the European CFO Forum is expected to set out its proposals for an alternative model for accounting for contracts with participating features. The IASB has asked that the papers for that session will set out the alternative model at a level that allows the IASB to consider how that model might be implemented at standards-level, and provide an analysis of the implications.

9. The IASB expects to publish the final Standard in 2015.

## Appendix A: The accounting model proposed by the IASB

A1. 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. That approach measures an insurance contract in a way that incorporates the following:

(a) a current, unbiased estimate of the cash flows expected to fulfill the insurance contract. The estimate of cash flows reflects the perspective of the entity, provided that the estimates of any relevant market variables do not contradict the observable market prices for those variables.

(b) an adjustment for the time value of money, using discount rates that reflect the characteristics of the cash flows. The discount rates are consistent with observable current market prices for instruments with cash flow characteristics that are consistent with those of the insurance contract and exclude the effect of any factors that influence the observable market prices but that are not relevant to the cash flows of the insurance contract.

(c) an adjustment for the effects of risk and uncertainty. The risk adjustment is defined as being the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arise as the entity fulfils the insurance contract.

A2. The underlying objective of this approach is to achieve a valuation of the insurance contract, including any options and guarantees embedded in the insurance contract, in a manner that is consistent with market information. However, the measurement of insurance contracts is a current expected value measurement rather than a fair value measurement. This reflects the IASB's conclusion that the fact that insurance contracts are not traded in active markets means that fair value would not be an appropriate measurement attribute for insurance contracts. Consequently, the valuation approach proposed by the IASB takes into account the fact that an entity expects to fulfil the contracts, rather than transfer them. That approach differs from fair value measurement in the following main areas:

(a) It does not reflect the non-performance risk of the entity that issues the insurance contract. In other words, the credit risk of the entity that issues the contract is not reflected in the measurement (paragraph 21 of the 2013 ED).

(b) The risk adjustment reflects the entity's—and not a market participant's—perception of the effects of uncertainty about the amount and timing of cash flows that arise from an insurance contract (paragraph B76 of the 2013 ED).

(c) A contractual service margin is recognised at inception, and allocated after inception (paragraph 32 of the 2013 ED), rather than being remeasured in a way that reflects a market participant's viewpoint.

(d) The measurement of an insurance contract does not have the equivalent of the requirement in paragraph 47 of IFRS 13 *Fair Value Measurement* that the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

A3. 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.

A4. However, the measurement approach in the 2013 ED reflects the IASB's view of an insurance contract as combining the features of both a financial instrument and a service contract and thus the IASB does not propose a fair value measurement for

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

the insurance contract. Because the service component and the financial instrument component of the contract are interrelated, the IASB does not propose that the components should be unbundled and accounted for separately. However, the IASB's model aims to ensure as much consistency as possible between the features of each component and the standalone component, had it been reported separately. As a result, the IASB's model treats changes in estimates relating to the two components differently:

(a) The entity accounts for changes in estimates relating to the service component in a way similar to the effect that would be achieved if the entity had applied the revenue recognition model to the component. As a result, changes in estimates relating to future service adjust the contractual service margin and are recognised in profit or loss when the related service is provided. Changes in estimates related to current or past periods' service would be recognised in profit or loss.

(b) The entity accounts for changes in estimates relating to the financial component in a way similar to the effect that would be achieved if the entity had applied the financial instruments model to the component. As a result, changes in estimates relating to the financial estimates are recognised in profit or loss or other comprehensive income.

A5. The following table summarises the treatment of changes in estimates for contracts with no participating features.

| 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 | In profit or loss in the period of |

| | |
|---|---|
| unrelated to service (for example, some deposits). | change (net interest and investment result). |
| Unwinding of discount based on discount rate at inception. | In profit or loss in period of unwind (net interest and investment result). |
| Effect of changes in discount rates since inception of the contract on the measurement of liability. | In other comprehensive income in the period of change. |
| Changes in the risk adjustment relating to current and past future service. | In profit or loss in the period of change. |
| Changes in the risk adjustment relating to future service. | Adjust contractual service margin, and recognised in profit or loss when future service provided. |

### *Presentation approach*

A6. The 2013 ED proposed a presentation approach for the statement of comprehensive income that would:

(a) align the presentation of revenue and expense with that required for other contracts with customers. This would make the financial statements of entities that issue insurance contracts easier to understand for generalist users of those financial statements.

(b) provide information about the main sources of profits for entities that issue insurance contracts.

(c) provide both a current and a cost-based view of the cost of financing an insurance contract. This would provide disaggregated information about the effects of changes in discount rates on the financial statements of entities that issue insurance contracts.

## Appendix C: Tentative decisions to date

The following table presents a summary of tentative decisions made in the redeliberations phase in 2014:

| Tentative decisions | Change from 2013 ED |
| --- | --- |
| (a) Differences between the current and previous estimates of the present value of expected cash flows and the risk adjustment 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.<br>(b) Differences between the current and previous estimates of the present value of cash flows and the risk adjustment that do not relate to future coverage and other future services should be recognised immediately in profit or loss.<br>(c) 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 losses that related to coverage and other services to be provided in the future.<br>(d) An entity should use the locked-in rate at inception of the contract for accreting interest and for determining the change in the present value of expected cash flows that offsets the contractual service margin. | The 2013 ED would:<br>• recognise all changes in estimates of risk adjustment immediately in profit or loss.<br>• rebuild the contractual service margin from zero without first reversing previously recognised losses in the profit or loss. |
| (a) An entity should choose to present the effect of changes in discount rates in profit or loss, or in other comprehensive income as its accounting policy and should apply that accounting policy to all contracts within a portfolio<br>(b) If the entity chooses to present the effect of changes in discount rates in other | The 2013 ED proposed that the effect of changes in discount rates should be required to be presented in OCI. |

| Tentative decisions | Change from 2013 ED |
|---|---|
| comprehensive income, the entity should:<br>(i) Recognise in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised; and<br>(ii) Recognise in other comprehensive income, the differences between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the carrying amount of the insurance contract was initially recognised.<br>(iii) Disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum to:<br>1. interest accretion at the discount rate that applied at initial recognition of insurance contracts reported in profit or loss for the period; and<br>2. the movement in other comprehensive income for the period.<br>(c) An entity should disaggregate total interest expense included in total comprehensive income to:<br>(i) the amount of interest accretion determined using current discount rates;<br>(ii) the effect on the measurement of the insurance contract of changes in discount rates in the period; and<br>(iii) the difference between the present value of changes in expected cash | |

| Tentative decisions | Change from 2013 ED |
| --- | --- |
| flows that adjust the contractual service margin in a reporting period when measured using discount rates that applied on initial recognition of insurance contracts, and the present value of changes in expected cash flows that adjust the contractual service margin when measured at current rates.<br>(d) For contracts with no participating features, an entity should use the locked-in rate at inception of the contract for accreting interest and for determining the change in the present value of expected cash flows that offsets the contractual service margin.<br>(e) An entity should apply the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to changes in accounting policy relating to the presentation of the effect of changes in discount rates. | |
| (a) An entity should present insurance contract revenue and expense in the statement of comprehensive income, as proposed in paragraphs 56–59 and B88–B91 of the 2013 ED; and<br>(b) An entity should disclose the following:<br>(i) a reconciliation that separately reconciles the opening and closing balances of the components of the insurance contract asset or liability (paragraph 76 of the 2013 ED);<br>(ii) a reconciliation from the premiums received in the period to the insurance contract revenue in the period (paragraph 79 of the 2013 ED);<br>(iii)the inputs used when determining the insurance contract revenue that is | The 2013 ED did not explicitly prohibit presenting premium information in the statement of comprehensive income if that information is not consistent with commonly understood notions of revenue. |

| Tentative decisions | Change from 2013 ED |
|---|---|
| recognised in the period (paragraph 81(a) of the 2013 ED); and<br>(iv) the effect of the insurance contracts that are initially recognised in the period on the amounts that are recognised in the statement of financial position (paragraph 81(b) of the 2013 ED).<br>(c) An entity should be prohibited from presenting premium information in the statement of comprehensive income if that information is not consistent with commonly understood notions of revenue. | |
| *Level of aggregation and portfolio definition*<br>• Clarify that the objective of the proposed insurance contracts Standard is to provide principles for the measurement of an individual insurance contract, but that in applying the Standard an entity could aggregate insurance contracts provided that it meets that objective.<br>• Amend the definition of a portfolio of insurance contracts to be: "insurance contracts that provide coverage for similar risks and are managed together as a single pool"<br>• Add guidance to explain that in determining the contractual service margin or loss at initial recognition, an entity should not aggregate onerous contracts with profit-making contracts. An entity should consider the facts and circumstances to determine whether a contract is onerous at initial recognition. | The definition of a portfolio in the 2013 ED is modified to eliminate the reference to "priced similarly relative to the risk taken on".<br>Added additional guidance and clarification |
| *Discount rate for long-term contracts when there is little or no observable market* | Added clarification of how the principle |

| Tentative decisions | Change from 2013 ED |
|---|---|
| *data*<br>• Confirm the principle that the discount rates used to adjust the cash flows in an insurance contract for the time value of money should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract<br>• Provide additional application guidance that, in determining those discount rates, an entity should use judgement to:<br>(i) ensure that appropriate adjustments are made to observable inputs to accommodate any differences between observed transactions and the insurance contracts being measured.<br>(ii) develop any unobservable inputs using the best information available in the circumstances, while remaining consistent with the objective of reflecting how market participants assess those inputs. Accordingly any unobservable inputs should not contradict any available and relevant market data. | should be applied in determining discount rates for insurance contracts. |
| *Asymmetric treatment of contractual service margin between insurance contracts issued and reinsurance contracts held*<br>• After inception, an entity should recognise in profit or loss any changes in estimates of fulfilment cash flows for a reinsurance contract that an entity holds when those changes arise as a result of changes in estimates of fulfilment cash flows for an underlying direct insurance contract that are recognised immediately in profit or | The 2013 ED proposed that, for a reinsurance contract that an entity holds, all changes in estimates of fulfilment cash flows relating to future service should be recognised and offset to the contractual service margin |

| Tentative decisions | Change from 2013 ED |
|---|---|
| loss. | |
| *Allocation of the contractual service margin to the profit or loss*<br>• Confirm the principle in the 2013 ED that an entity should recognise the remaining contractual service margin in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of the services that are provided under an insurance contract.<br>• Clarify that, for contracts with no participating features, the service represented by the contractual service margin is insurance coverage that:<br>(i) is provided on the basis of the passage of time; and<br>(ii) reflects the expected number of contracts in force. | The 2013 ED stated only that an entity should recognise the remaining contractual service margin in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of the services that are provided under an insurance contract. |
| *Significant insurance risk*<br>Clarify the guidance in paragraph B19 of the 2013 ED that significant insurance risk only occurs when there is a possibility that an issuer will incur a loss on a present value basis. | The 2013 ED referred more specifically to the need for a scenario with commercial substance in which the present value of the net cash outflows can exceed the present value of the premiums. |
| *Portfolio transfers and business combinations*<br>Clarify the requirements for the contracts acquired through a portfolio transfer or a business combination in paragraphs 43-45 of the 2013 ED, that such contracts should be accounted for as if they had been issued by the entity at the date of the | Clarification of requirements in the 2013 ED to avoid difference in interpretation. |

| Tentative decisions | Change from 2013 ED |
|---|---|
| portfolio transfer or business combination. | |
| *Fixed fee service contracts*<br>Entities should be permitted, but not required, to apply the revenue recognition Standard to the fixed-fee service contracts that meet the criteria stated in paragraph 7(e) of the 2013 ED. | The 2013 ED excluded all fixed fee service contracts from its scope. |
| *Premium-allocation approach*<br>• Clarify that when an entity applies the premium-allocation approach to account for an insurance contract, it should recognise insurance contract revenue in profit or loss:<br>(a) on the basis of the passage of time; but<br>(b) if the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits.<br>• When an entity applies the premium-allocation approach to contracts for which the entity:<br>(a) discounts the liability for incurred claims; and<br>(b) chooses to present the effect of changes in discount rates in OCI;<br>the interest expense in profit or loss for the liability for incurred claims should be determined using the discount rate that is locked in at the date the liability for incurred claims is recognised. This tentative decision also applies to the | The 2013 ED required that an entity should allocate the expected premium receipts as insurance contract revenue to each accounting period in the systematic way that best reflects the transfer of services that are provided under the contract.<br><br>The 2013 ED required that interest expense on insurance liabilities should be determined using the discount rates that applied at the date that the contract was initially recognised. |

| Tentative decisions | Change from 2013 ED |
|---|---|
| presentation of interest expense for any onerous contract liability that is recognised when the entity applies the premium-allocation approach. | |
| *Issues that will not be addressed*<br>In April 2014 the IASB tentatively decided not to consider in future meetings other non-targeted issues, including those relating to:<br>(i) disclosures;<br>(ii) combination of insurance contracts;<br>(iii) contract boundary for specific contracts;<br>(iv) unbundling—lapse together criteria;<br>(v) treatment of ceding commissions;<br>(vi) discount rate—top-down and bottom-up approaches;<br>(vii) tax included in the measurement; and<br>(viii) combining the contractual service margin with other comprehensive income. | None |

## Appendix C: Extending the general proposals to contracts with participating features

A7. Paragraph 7 states that the staff's approach for contracts with participating features is to consider the adaptations that would be needed if the general proposals were to be applied to contracts with participating features. The IASB's tentative decisions to date would apply to contracts with participating features as follows:

(a) The cash flows would include the expected cash flows that arise from the returns of the underlying items that the entity expects to be passed to the policyholder. This has two important consequences:

(i) when a contract provides an entity with discretion over the timing and/or amount of the returns from underlying items that are passed to policyholders, the fulfilment cash flows include the cash flows that are subject to the entity's discretion. The IASB viewed such payments as arising out of the obligation in the contract to share in the returns of the underlying items with the policyholder.

(ii) the fulfilment cash flows reflect the returns to be passed to the policyholder, even if the entity invests in underlying items that generate a different return. When that is the case, the difference between the returns on the entity's investments and the returns to be paid to policyholders provides useful information to investors on the economic mismatches arising between the items held by the entity and the entity's obligations arising from the contract. In such cases, because the underlying items generate a different return they do not impact the cash flows of the insurance contract.

(b) The discount rates used to adjust those cash flows for the time value of money should reflect the extent of dependence of the amount, timing or uncertainty of the cash flows that arise from the insurance contract on the returns on underlying items. This ensures consistency between the

cash flows and the discount rates used to adjust those cash flows for the time value of money.

(c) The risk adjustment would reflect the compensation the entity would require for bearing the uncertainty about those cash flows. No adaptations are needed for the risk adjustment.

(d) The contractual service margin would be determined at initial recognition to eliminate any Day 1 gain. Subsequent to initial recognition, the contractual service margin would be adjusted to reflect changes in estimates that relate to future services.

(e) Interest expense would be reported in profit or loss using discount rates that are determined at the date when the contract was initially recognised, updated to reflect changes in returns on underlying items that are expected to affect the amount of cash flows to the policyholder.

A8. The IASB has considered the adaptations that might be made to the general model, in particular whether there is a need to adjust the contractual service margin for the insurer's share of returns from underlying items, and whether the interest expense presented in profit or loss should be modified. The IASB has directed the staff to:

(a) consider adjusting changes in insurer's share of returns from underlying items against the CSM *only* when those changes can be viewed as an implicit management fee. The IASB believes this to be the case only when:

(i) the returns to be passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items or whether the entity has discretion over the payments to policyholders);

(ii) there is a minimum amount (either fixed or determinable) that the entity must retain; and

(iii) the policyholder will receive a substantial share of the total return on underlying items.

(b) explore two approaches for determining the discount rate used for the presentation of interest expense in profit or loss: a book yield approach and an effective interest method approach, both of which would avoid the requirement to apply different discount rates to different sets of cash flows. The IASB directed the staff to restrict the applicability of these approaches as follows:

(i) the book yield approach should be considered only for contracts in which:

1. the returns passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items); and
2. the policyholder will receive a substantial share of the total return on underlying items.

(ii) The effective interest method approach should be considered only for contracts in which the cash flows that vary with underlying items are a substantial proportion of the total benefits to the policyholder over the life of the contract.

A9. The staff expect to ask the IASB to make tentative decisions for the model for accounting for contracts with participating features as a whole. After evaluating that model, the staff will consider whether any form of the mirroring exception should be required. We note that eliminating a requirement for the mirroring exception as proposed in the 2013 ED would eliminate any need to bifurcate cash flows for measurement.