AGENDA PAPER

IFRS Foundation Trustees meeting – Due Process Oversight Committee

LONDON	26 JANUARY 2016	Agenda ref	3C(ii)
PRESENTER	Henry Rees		

Insurance Contracts Project: Draft Paper for February meeting – assessing the changes since the 2013 Exposure Draft

1. The attached paper is a draft for the February 2016 meeting of the International Accounting Standards ('the Board'). The paper refers to other papers that the staff expects to present for that meeting that will be available on the Board's website in due course.

STAFF PAPER

February 2015

IASB Meeting

Project	Insurance contracts		
Paper topic	**Assessing the changes since the 2013 ED**		
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Introduction

1. This paper sets out the staff's view, relative to the requirements of the International Accounting Standards Board's (the Board's) *Due Process Handbook*, on why the Board need not re-expose the new insurance contracts Standard. The staff's view reflects consideration of:

   (a) the Board's tentative decisions since its 2013 Exposure Draft *Insurance Contracts* (2013 ED) (summarised in the Appendix), which respond to the feedback received; and

   (b) the extensive consultation that the Board has undertaken throughout the whole of the project in the form of consultation documents, formal and informal meetings (including advisory committee, insurance working group, roundtables and discussion forums). That consultation:

      (i) provided respondents with the opportunity to comment on all aspects of the proposed new insurance contracts Standard, including the changes since the 2013 ED; and

      (ii) means that the Board is unlikely to learn anything new by re-exposing the proposals.

2. This paper has been provided to support the Board's decision on Agenda Paper 2F *Permission to ballot a Standard on insurance contracts and Due Process*

Summary, which requests permission for the staff to begin the balloting process for an IFRS on accounting for insurance contracts. It:

(a) sets out the Board's criteria for re-exposure in paragraph 3;

(b) evaluates the revisions to the 2013 ED against those criteria in paragraphs 4-15;

(c) weighs the costs of re-exposure against the benefits in paragraphs 16-1919; and

(d) provides the staff's conclusions that the Board should finalise the requirements based on the Board's tentative decisions to date in paragraphs 20-21.

The Board's re-exposure criteria

3. The *Due Process Handbook* sets out the criteria to be considered with respect to re-exposure, as follows:

> *Re-exposure criteria*
>
> 6.25 In considering whether there is a need for re-exposure, the IASB:
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> (a) identifies substantial issues that emerged during the comment period on the Exposure Draft and that it had not previously considered;
>
> (b) assesses the evidence that it has considered;
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> (c) determines whether it has sufficiently understood the issues, implications and likely effects of the new requirements and actively sought the views of interested parties; and
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> (d) considers whether the various viewpoints were appropriately aired in the Exposure Draft and adequately discussed and reviewed in the Basis for Conclusions.
>
> 6.26 It is inevitable that the final proposals will include changes from those originally proposed. The fact that there are changes does not compel the IASB to re-expose the proposals. The IASB needs to consider whether

> the revised proposals include any fundamental changes on which respondents have not had the opportunity to comment because they were not contemplated or discussed in the Basis for Conclusions accompanying the Exposure Draft. The IASB also needs to consider whether it will learn anything new by re-exposing the proposals. If the IASB is satisfied that the revised proposals respond to the feedback received and that it is unlikely that re-exposure will reveal any new concerns, it should proceed to finalise the proposed requirements.
>
> 6.27 The more extensive and fundamental the changes from the Exposure Draft and current practice the more likely the proposals should be re-exposed. However, the IASB needs to weigh the cost of delaying improvements to financial reporting against the relative urgency for the need to change and what additional steps it has taken to consult since the Exposure Draft was published. The use of consultative groups or targeted consultation can give the IASB information to support a decision to finalise a proposal without the need for re-exposure.
>
> 6.28 The IASB should give more weight to changes in recognition and measurement than disclosures when considering whether re-exposure is necessary.

Evaluating the revisions to the Exposure Draft

4. The Appendix summarises the Board's tentative decisions in the redeliberations on the 2013 ED. The staff notes that in most cases, the Board confirmed the proposals in the 2013 ED, with only minor amendments. As a result, the Board's model as a whole does not differ fundamentally to the model proposed in the 2010 Exposure Draft *Insurance Contracts* (2010 ED) or the 2013 ED on which the Board has received extensive feedback.

5. The staff observes that most of the changes made to the proposals in the 2013 ED are not significant and all changes had been in response to concerns and suggestions made in the comment letters and subsequent outreach. These changes include:

(a) A change to an alternative that was rejected by the Board in the Basis for Conclusions to the 2013 ED, but which the Board has reconsidered, based on the relative weighting of arguments following review of the comment letters and other outreach (discussed further in paragraph 6).

(b) Practical accommodations in applying the principles in the 2013 ED which has been made in response to concerns raised by interested parties.

(c) Clarification of the Board's intentions in the 2013 ED (either by articulating the proposals differently or by adding guidance), made in response to concerns that interested parties identified as they sought to interpret the 2013 ED.

(d) Simplification of the proposals in the 2013 ED, usually in response to concerns raised in the comment letters.

6. However, there are two significant areas of change, both of which relate to the accounting treatment for insurance contracts with participation features:

(a) The introduction of the variable fee approach for measuring some participating contracts. The variable fee approach replaces the mirroring exception proposed by the Board in its 2013 ED. It regards the insurance contract as creating an obligation to pay to the policyholder an amount equal to 100% of the fair value of the underlying items less a variable fee for service. Changes in the variable fee for service are required to be recognised as an adjustment to the contractual service margin, except when an entity uses derivatives to mitigate financial market risks in such contracts. An entity that uses derivatives to mitigate the financial market risk from a guarantee embedded in those insurance contracts would be permitted to minimise accounting mismatches by recognising changes in the value of the embedded guarantee in profit or loss in specified circumstances.

(b) The changes to the requirements for the disaggregation of the effect of financial market variables between profit or loss and other comprehensive income (OCI). In particular, the addition of a requirement that a current period book yield approach could be applied is specified circumstances when there are no economic mismatches between the insurance contracts accounted for under the variable fee approach and the items held.

7. As noted in Agenda Paper 2B *Overview of the new insurance contracts Standard* there are two differences between the variable fee approach and the general model:

(a) the recognition of the effect of changes in financial market variables on financial guarantees embedded in insurance contracts: and

(b) measurement of the contractual service margin after initial recognition.

8. Accordingly, in introducing the variable fee approach, the Board considered:

(a) the scope for the variable fee approach; and

(b) whether to eliminate the differences between the variable fee approach and the general model.

9. Paragraph 6.26 of the *Due Process Handbook* notes that it is inevitable that the final proposals will include changes from those originally proposed, and that the fact that there are changes does not compel the Board to re-expose the proposals. The staff has assessed the changes against the requirements in paragraph 6.26 of the *Due Process Handbook*, as follows:

(a) The staff thinks that the revised proposals do not include any fundamental changes. The staff notes that, in the deliberations leading to the 2013 ED, the Board had previously considered alternative ways to depict the connection between an insurance contract with participating features and the underlying items. In particular:

(i) the change described in paragraph 6(a) is a variation of the approach described and rejected in paragraphs BC38-BC41 of the Basis for Conclusions to the 2013 ED (adjusting the contractual service margin by changes in the carrying amount of underlying items), and has similar features. In addition, this approach is partly consistent with adjusting the contractual service margin for changes in estimates related to future service.

(ii) the change described and rejected in paragraph 6(b) shares some of the presentation features of the mirroring approach proposed in the 2013 ED, which depicts the connection between the insurance contract and underlying items by measuring and presenting changes in the insurance contract on the same basis as the measurement and presentation of the underlying items. Although the comment letters and outreach persuaded the Board that the mirroring approach would not be appropriate for measuring insurance contracts, the Board decided to retain those presentation features. In addition, there are similarities between the current period book yield approach and the approach described in paragraphs BC158 and BC159 of the Basis for Conclusions to the 2013 ED (resetting the discount rate to the book yield).

(b) Respondents have had the opportunity to comment on the proposed changes through extensive outreach between June 2013 and December 2015 (ie during the comment period for the 2013 ED and subsequently), as follows:

(i) Board members and staff held approximately 400 meetings with individuals and groups of preparers, users, actuaries, auditors, regulators and others in order to test proposals, hear views, explore implications and understand concerns raised by affected parties. These meetings included:

1. targeted meetings with users of financial statements in the US, Europe and Asia;
2. A series of discussion forums in 18 countries between May 2013 and November 2013 organised in conjunction with national standard setters and others. Our outreach plan aimed to ensure a broad coverage of views, and focused on the biggest insurance markets. However, we also sought to balance outreach in the biggest jurisdictions with outreach in smaller markets that are expected to grow, and in markets with which we have had less interaction;
3. a regular and active dialogue with regulators, standard-setters and industry representative groups; and
4. participation at many public events to exchange views with constituents.

(ii) In developing the variable fee approach and current period book yield approach, the Board supplemented the feedback in the comment letters and user outreach through extensive interaction with preparers of financial statements, regulators, auditors. In particular, the Board invited the European CFO Forum, an association of the 20 largest insurers in Europe, to present an education session outlining their proposals for participating contracts. Those proposals were subsequently discussed with groups representing views from Asia-Oceania, North America and Europe, including the Accounting Standards Advisory Forum.

(c) The staff believes Agenda papers 2C *Comparison of the IASB's tentative decisions with the comment letter summary* and 2D *The development of the requirements for the accounting for insurance contracts* demonstrate that the proposed new Standard responds to the feedback received, both on the 2013 ED and on earlier consultation documents.

10. Paragraph 6.27 of the *Due Process Handbook* notes the use of consultative groups or targeted consultation can give the Board information to support a decision to finalise a proposal without the need for re-exposure. The Board has not held a formal meeting of its Insurance Working Group since June 2012. This reflects that, as with most project work groups, the bulk of the Insurance Working Group meetings were at the beginning of a project's life, when the initial ED was contemplated. However, as a project advances towards its final stages, the role of the working group evolves to that of a group of experts that the Board can call on to get specific advice on specific elements of the proposals standard. That stage does not usually require formal meetings of the group. Accordingly, the staff has sought the expertise of Insurance Working Group members on an individual basis throughout the redeliberations. For example:

    (a) Members of the Insurance Working Group were invited to participate in a fatal flaw review of an early draft of the 2013 ED.

    (b) The staff and some board members have actively sought the views of some members of the Insurance Working Group and their colleagues through a continuing dialogue conducted through informal meetings and correspondence.

11. The staff expect to continue to draw on the expertise of knowledgeable practitioners, which include working group members, as relevant in finalising the Standard.

12. Paragraph 6.27 of the *Due Process Handbook* also refers to the role of targeted consultation. The Board conducted targeted outreach to seek comments from a wide range of jurisdictions on the revised proposals for contracts with participating features. In doing so, the Board was made aware of concerns about

the application of the variable fee approach when an entity uses derivatives to mitigate risks from financial guarantees embedded in insurance contracts.

13. In response to those concerns, the Board conducted further targeted outreach with interested parties in different jurisdictions that currently use derivatives to mitigate risks from financial guarantees embedded in insurance contracts. That outreach was focussed on understanding how entities measured the extent of risk mitigation and avoided accounting mismatches under their existing reporting, and in understanding their likely views on the approaches proposed by the staff. The Board used the information learned as a result of that outreach in developing the exception from the variable fee approach that is described in paragraph 6(a).

14. Accordingly, as a result of both general opportunities for respondents to comment and targeted outreach on proposed changes, the staff thinks it is unlikely that the Board will learn anything significantly new by re-exposing the proposals or that re-exposure will reveal new concerns.

15. Furthermore, the staff note that the variable fee approach measures the fulfilment cash flows in the same way as the general model. The Board has previously tested the operationality of the approach for measuring fulfilment cash flows through fieldwork. In addition, that approach has features similar to those existing in some areas, for example in risk-based solvency reporting (eg Solvency II in Europe) and internal reporting of some companies. The staff also note that the determination of the contractual service margin is builds on the estimates used to measure and adjust the contractual service margin. Consequently, staff do not think re-exposing the proposals will highlight significant issues on operationality that the Board has not previously considered.

Weighing the costs of re-exposure against the benefits

16. Paragraph 6.27 of the *Due Process Handbook* also suggests that the Board should consider the costs of delaying improvements to financial reporting against the

relative urgency for the need to change and what additional steps it has taken to consult since the Exposure Draft was published.

17. The staff notes that some interested parties have already stated their view that the Board should re-expose the insurance contracts Standard, in view of the significant change that the Standard will cause to existing practice and the complexity of the proposed Standard, as well as what they perceive as substantial changes to the proposals set out in the 2013 ED. If the Board takes the decision not to re-expose, we need to be ready to answer the calls that we should re-expose. The staff notes that there would be a significant delay to the issuance of a Standard on insurance contracts if the Board were to decide to re-expose any proposals. This is because many aspects of the accounting for insurance contracts are interrelated. Making changes in one area without reconsidering interrelated areas can cause anomalous effects. To avoid such anomalous effects, the Board needs to consider issues from a broader perspective, which increases the time needed to develop proposals.

18. Furthermore, the staff observes that the Board’s process has led to the Board making many amendments to its original model, and in some cases further amending those amendments. Although the amendments respond to the feedback received on each of the consultation documents (as demonstrated in Agenda Papers 2C and 2D), they have increased the complexity of the model. Making further amendments to this model, as would be inevitable if the Board were to re-expose, would increase that complexity and could make it difficult to understand the underlying principles.

19. Finally, the staff thinks that the costs of delaying improvements to financial reporting for insurance contracts through additional consultation need to be considered in the light of the feedback from users of financial statements and the

statement issued by the FSB Plenary at its meeting in September 2015, which noted the high priority of the project.[1]

Staff conclusions

20. In the staff's view, although there are changes from those originally proposed in the 2013 ED:

    (a) the Board's tentative decisions since its 2013 ED respond to the feedback received and do not include any fundamental changes on which respondents have not had the opportunity to comment; and

    (b) the extensive consultation that the Board has undertaken throughout the whole of the project mean it is unlikely that the Board will learn anything significantly new by re-exposing the proposals or that re-exposure will reveal any new concerns.

21. Accordingly, the staff believe the Board should proceed to finalise the requirements based on the Board's tentative decisions to date.

[1] See press release at http://www.fsb.org/2015/09/meeting-of-the-financial-stability-board-in-london-on-25-september/

Appendix: Revisions to the Exposure Draft

A1. The following table summarises the changes to the 2013 ED as a result of the Boards' redeliberations in response to concerns expressed in the comment letters to the 2013 ED. We use the following symbols to indicate status of the Board's tentative decisions:

✓ Confirmation of proposal

+ Additional guidance provided

§ Change from the ED

	2013 ED Proposal	Tentative decisions	Staff comment
Scope			
1	**Fixed fee service contracts** Entities required to apply IFRS 15 *Revenue from Contracts with Customers* to specified fixed fee service contracts, even when they meet the definition of an insurance contract.	§ Permit entities to apply IFRS 15 or the new insurance contracts Standard to fixed fee service contracts that meet the definition of an insurance contract.	Minor change from ED to provide operational relief to some entities, eg companies offering motor insurance policies that include a roadside assistance.
2	**Definition of significant insurance risk** Defines insurance risk and provides guidance on assessing when insurance risk is significant.	+ Additional clarification provided.	No substantive change to ED.
Measurement			
3	**Contracts with participating features** Proposed a "mirroring exception" that required entities to measure and present cash flows that vary directly with underlying items in the same way as	§ Replaced the mirroring exception for contracts for which there can be no economic mismatch between the insurance contract and assets backing that contract with the variable fee approach for	Significant change to the ED proposals in response to feedback on the ED. See paragraphs 6-9.

	the underlying items are measured and presented.	contracts with direct participation features. § Introduced an approach to permit entities that apply the variable fee approach and use derivatives measured at FVPL to mitigate the financial market risk from the guarantee embedded in the insurance contract to recognise the change in the value of the guarantee in profit or loss.	
4	**Discount rates for long-term contracts when there are few or no observable market inputs** 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.	✓Confirmed principle. + Additional application guidance provided.	No substantive change to ED.
5	**Unlocking the contractual service margin** Adjust contractual service margin prospectively for changes in estimates of cash flows.	✓Confirmed principle that the contractual service margin should be adjusted for changes in estimates of cash flows. § Additionally, unlock contractual service margin for changes in risk adjustment. § Recognise in profit or loss favourable changes in estimate to the extent that they reverse losses that relate to coverage and other services provided in the future.	Change to increase consistency: • between the treatment of changes in the risk margin and the cash flows; and • with the revenue recognition requirements.
6	**Recognising the contractual service margin in profit or loss** Recognise 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.	+ Add guidance that the contractual service margin is recognised in profit or loss on the basis of the passage of time. + Aligned the pattern that applies to insurance contract revenue in the premium allocation approach with the general model.	Minor change from ED to respond to feedback that a more principles- based requirement would result in inconsistent application.
7	**Level of aggregation and definition of portfolio**	+ Please refer to the staff recommendations in	Minor change to ED proposals to clarify

	States that contractual service margin should be measured at the level of a portfolio of insurance contracts, and provides guidance on what contracts may be combined into the same portfolio. Defines a portfolio of insurance contracts as "group of insurance contracts that: (a) Provide coverage for similar risks and that are priced similarly relative to the risk taken on; and (b) Are managed together as a single pool."	Agenda Paper 2A *Level of aggregation* for the January 2016 meeting. + Delete reference to 'priced similarly relative to the risk taken on' from the definition of a portfolio.	Board's intent.
8	**Portfolio transfers and business combinations** Provides requirements for measuring contracts acquired through portfolio transfer or business combinations.	+ Additional clarification provided.	No substantive change to ED.
9	**Asymmetrical treatment of gains for reinsurance contracts that an entity holds** Gains and losses on reinsurance contracts held by the entity are recognised over the coverage period.	§ Introduces an exception for recognition of changes in estimates of fulfilment cash flows for a reinsurance contract an entity holds to avoid an accounting mismatch.	Minor change to ED proposals to avoid accounting mismatches.
10	**Rate used to accrete interest and calculate the present value of cash flows that is offset against the CSM** Use 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.	✓Confirmed ED proposals.	No change from ED.
Presentation			
11	**Presenting insurance contract revenue and expense** Present insurance contracts revenue and expense in statement of comprehensive income. Exclude investment components from insurance	✓Confirmed proposals in ED.	No change from ED.

	contracts revenue and expense.		
12	**Determination of interest expense in profit or loss** Present interest expense in profit or loss on a cost basis, and present in OCI changes in the insurance contract arising from changes in the discount rate.	§ permit entities to choose accounting policy to present effect of changes in discount rates in profit or loss, or in OCI. § require that changes in estimates of the amounts of cash flows resulting from changes in market variables should be presented in the statement of comprehensive income consistently with the changes in discount rates (affects contracts with participating features only). § clarify that the objective of disaggregating changes arising from changes in market variables between profit or loss and OCI is to present an insurance investment expense in profit or loss using a cost measurement basis, and not to specify detailed mechanics for the determination of the insurance investment expense. § Introduction of an optional 'current period book yield approach' when there is no economic mismatches between the insurance contract and the items held. The current period book yield approach eliminates accounting mismatches in profit or loss.	• Change to permit an accounting policy choice in response to widespread feedback that requiring effects of changes in discount rate to be recognised in OCI for all entities would introduce accounting mismatches and significant complexity and operational burden for some entities. • Change to require changes in estimates of cash flows resulting from changes in market variables to be presented consistently with changes in discount rates responds to feedback on the 2013 ED. • Clarification of objective addresses concerns about the difficulty of stating a prescriptive methodology for OCI. • Introduction of current period book yield approach responds to feedback from interested parties and is discussed in paragraphs 6-9.
13	**Determination of interest expense in the premium-allocation approach** When OCI accounting policy selected, discount rate for determining interest expense in profit or loss in the premium allocation approach is locked in at the inception of the contract.	§ permits an entity to determine the interest expense in profit or loss using the discount rate that is locked in at the date the liability for incurred claims is recognised.	Minor change from ED to reduce operational complexity and costs.
Transition			
14	**Transition** • Retrospective application with specified simplifications when retrospective application	§ provide an additional simplification for determining the risk adjustment at initial recognition.	• Change from ED proposes further simplifications for when retrospective application is impracticable response to

is impracticable. • Provide transition reliefs for entities that had previously applied IFRS 9 *Financial Instruments* (IFRS 9).	§ provide an additional simplification for determining insurance investment expense and related accumulated balance of OCI for contracts in which changes in market variables affects the amount of cash flows. § provide an additional ‘fair value approach’ for determining the contractual service margin when the simplified approach is impracticable. ✓ confirm transition reliefs for entities that had previously applied IFRS 9. § provide additional transition relief to permit entities to reassess the business model for some financial assets for entities that had previously applied IFRS 9.	concerns about the impracticability of the simplified transitional proposals. • Additional reliefs provided for entities that had previously applied IFRS 9. • In December 2015, the Board has also issued an Exposure Draft of proposals to address other concerns related to the application of IFRS 9 prior to the new insurance contracts Standard.