

## STAFF PAPER

June 2016

## IASB Meeting

<b>Project</b>	<b>Insurance contracts</b>		
<b>Paper topic</b>	Presentation and disclosure of insurance finance income or expenses		
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**Purpose of this paper**

1. This paper considers whether the requirements for the presentation and disclosure of insurance finance income or expenses<sup>1</sup> should be amended.

**Structure of this paper**

2. This paper considers the following aspects of insurance finance income or expenses:
  - (a) whether an entity should be required to disaggregate a change in the risk adjustment to present a finance component and an underwriting component (paragraph 5);
  - (b) how the forthcoming insurance contracts Standard should specify the presentation in profit or loss (P&L) and other comprehensive income (OCI) for contracts that are not eligible for the current period book yield approach (paragraphs 6 to 18); and

<sup>1</sup> Insurance finance income or expenses arising on insurance contracts is defined as the change in the effect of the time value of money arising from the passage of time and the effect of changes in financial assumptions.

- (c) what disclosures should be required to explain the amount of insurance finance income or expenses in a period (paragraphs 19 to 24)
3. The Appendices provide:
- (a) a summary of the tentative decisions to date (Appendix A); and
  - (b) an illustrative example of a systematic allocation of insurance finance income or expenses based on crediting rates (Appendix B).

### **Staff recommendations**

4. The staff recommend that:
- (a) an entity need not disaggregate the change in the risk adjustment into a finance component and an underwriting component. If the entity does not make such a disaggregation, it should present the entire change in the risk adjustment as part of the underwriting result;

### ***Presentation of insurance finance income or expenses***

- (b) if an entity disaggregates insurance finance income or expenses of a contract for the period between P&L and OCI, the Standard should:
  - (i) **not** specify the objective of disaggregating finance income or expenses as being to present insurance finance income or expenses in P&L on a cost measurement basis;
  - (ii) instead, specify that the entity should present in P&L a systematic allocation of the total expected insurance finance income or expenses over the life of the contract;
- (c) the Standard should provide guidance that, in this context, a systematic allocation:
  - (i) is based on characteristics of the contract without reference to factors that do not affect the measurement of the contract. For example, the allocation of the total expected finance income or expenses should not be based on expected recognised returns from assets if those

- expected recognised returns do not affect the measurement of the fulfilment cash flows; and
- (ii) results in the amounts recognised in OCI over the life of the contract totalling zero;
- (d) the Standard should provide further guidance that:
- (i) for insurance contracts for which changes in financial assumptions do not have a substantial effect on the amounts paid to the policyholder, the systematic allocation is determined using the discount rate(s) applicable at the inception of the contract;
  - (ii) for insurance contracts for which changes in financial assumptions have a substantial effect on the amounts paid to the policyholder, a systematic allocation can be determined in different ways, for example:
    1. using a rate that allocates the remaining revised expected finance expenses over the remaining life of the contract at a constant rate; or
    2. for contracts that use a crediting rate to determine amounts due to the policyholder, using an allocation that is based on the amounts credited in the period and expected to be credited in future periods;

### ***Disclosure of insurance finance income or expenses***

- (e) an entity should not be required to disclose a specified breakdown of total insurance finance income or expenses;
- (f) an entity should be required to explain the total amount of insurance finance income or expenses in a reporting period and combine this with requirements to:
  - (i) highlight the relationship between insurance finance income or expenses and investment returns on the related assets the entity holds in order to provide investors with sufficient information for them to understand the sources

of net financial income or expenses in the statement of profit or loss and other comprehensive income; and

- (ii) disclose an explanation of the methods that the entity uses to calculate the information presented in P&L.

## **Staff analysis of tentative decisions and recommended changes**

### ***Disaggregating a change in the risk adjustment to present a finance component and an underwriting component***

5. The working draft of the insurance contract Standard defines insurance finance income or expenses arising on insurance contracts as the change in the effect of the time value of money arising from the passage of time and the effect of changes in financial assumptions. This definition includes changes in the present value of the future cash flows, the risk adjustment and the contractual service margin. However, as the staff have previously noted, it is not feasible to require entities to identify the effect of a change in discount rate on the risk adjustment given the different techniques that are available for measuring the risk adjustment.<sup>2</sup> The staff continue to hold this view, and accordingly propose to specify in the Standard that an entity need not disaggregate the change in the risk adjustment to present a finance component and an underwriting component. If the entity does not make such a disaggregation, it should present the entire change in the risk adjustment as part of the underwriting result.

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<sup>2</sup> July 2014 Agenda Paper 2B.

**Question 1. Disaggregating a change in the risk adjustment to present a finance component and an underwriting component**

Does the Board agree to specify that:

- (a) an entity need not disaggregate the change in the risk adjustment into a finance component and an underwriting component; and
- (b) if the entity does not make such a disaggregation, it should present the entire change in the risk adjustment as part of the underwriting result?

***Presentation of insurance finance income or expenses***

6. In September 2015 the Board tentatively decided:
- (a) that the objective of disaggregating changes in the insurance contract arising from changes in financial assumptions between P&L and OCI is to present an insurance finance income or expenses in P&L using a cost measurement basis;
  - (b) that, in this context, a cost-measurement basis is a systematic allocation of the insurance finance income or expenses over the life of the contract; and
  - (c) not to specify detailed mechanics for the determination of insurance finance income or expenses in P&L, but to provide examples of allocating insurance finance expenses on a systematic basis.

***Cost measurement basis***

7. The staff observe that the examples of allocation on a systematic basis given in the September 2015 Board paper are not all consistent with use of the term ‘cost’ in other Standards. Some of those examples go beyond the methods used to measure financial assets and liabilities at amortised cost, for example using crediting rates that do not approximate to the effective yield. Furthermore the staff questions whether the label ‘cost measurement basis’ is necessary.

8. Accordingly, the staff recommend that the Board removes the reference to a cost measurement basis as the objective of presenting insurance finance income or expenses in P&L when an entity disaggregates total insurance finance income or expenses between P&L and OCI.

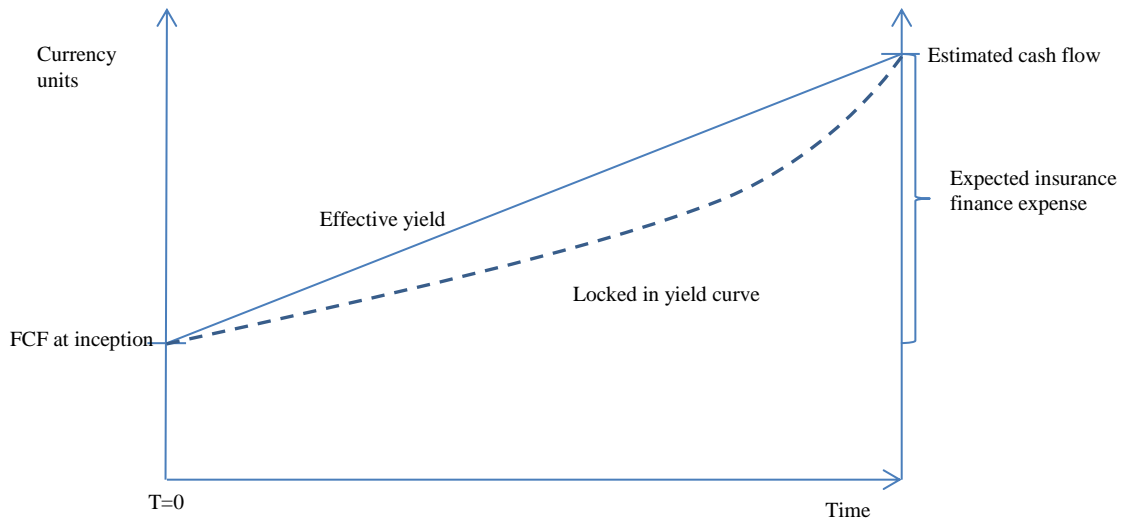
*Systematic allocation of expected insurance finance income or expenses*

9. If the Board agrees to remove the reference to a cost measurement basis, the staff think that the Standard should give some alternative guidance on what a systematic allocation means. The staff propose that a systematic allocation is described in the Standard as an allocation of the total expected finance income or expenses of a contract over the life of the contract in a way that:
- (a) is based on the characteristics of the contract, without reference to factors that do not affect the measurement of the contract. For example, the allocation of the total expected finance income or expenses should not be based on expected recognised returns from assets if those expected recognised returns do not affect the measurement of the fulfilment cash flows; and
  - (b) results in the amounts recognised in OCI over the life of the contract totalling zero.
10. For example, the current period book yield (ie an amount based on recognised asset returns) is not a systemic allocation based on the characteristics of the liability and hence is appropriate only in the limited circumstances in which no economic mismatch between the assets and insurance contract liabilities could occur. (See September 2015 Agenda Papers 2B and 2C.)
11. The requirement that amounts in OCI should reverse under a systematic allocation of insurance finance income or expenses to P&L over the life of a contract is in accordance with the Board's previous tentative decisions.
12. For insurance contracts for which changes in financial assumptions do not have a substantial effect on the amounts paid to the policyholder, the systematic allocation is determined using the discount rate(s) applicable at the inception of the contract. This means that insurance finance income or expenses recognised in P&L could be based on a single effective yield or a yield curve (a series of

rates) that discount estimated cash flows to a present value equal to the carrying amount.

Systematic allocation of expected insurance finance income or expenses:

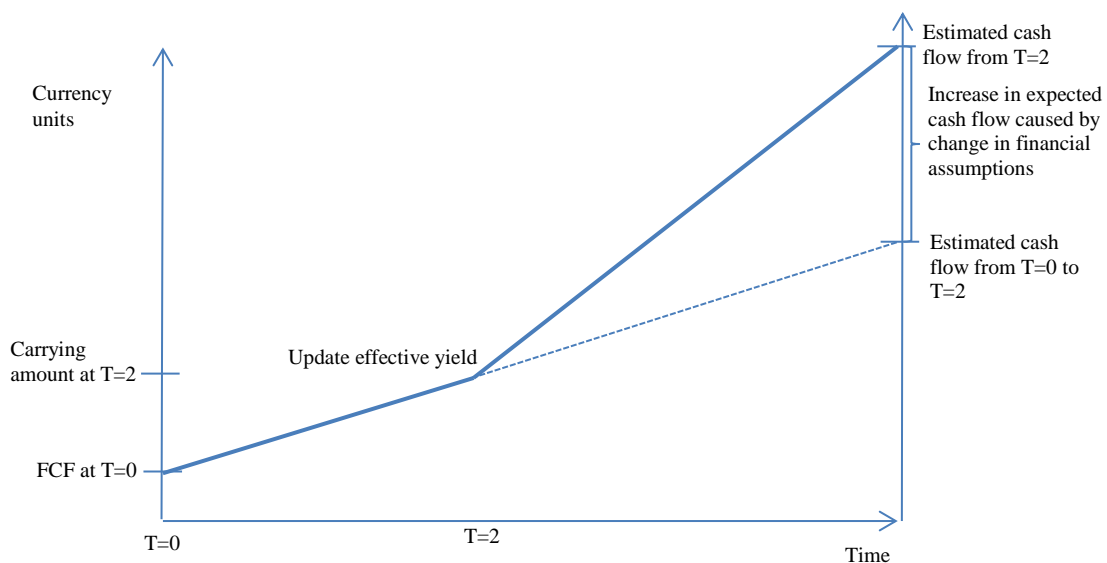
Effective yield or a yield curve



13. For insurance contracts for which changes in financial assumptions have a substantial effect on the amounts paid to the policyholder, a systematic allocation can be determined in different ways. One example is using a rate that allocates the remaining revised expected finance expenses over the remaining life of the contract at a constant rate.

Systematic allocation of expected insurance finance income or expenses:

Update effective yield if expected cash flows change due to a change in financial assumptions



14. Another example of a systematic allocation, for contracts which use a crediting rate to determine amounts due to the policyholder, is to use an allocation that is based on the amounts credited in the period and expected to be credited in future periods. Such an approach (sometimes referred to as the projected crediting method) was previously considered by the Board in September 2015 (Agenda Paper 2B) and September 2014 (Agenda paper 2A). The staff provide a simple example of the projected crediting method in Appendix B. The staff think that a projected crediting method meets the criterion in paragraph 9(a) because crediting rates directly affect the expected cash flows and hence the measurement of a contract.
15. Because the projected crediting method results in an entity recognising in P&L insurance finance expenses that reflect the amount the entity credits to policyholders in each reporting period, the staff considered whether there should be any restriction in applying this approach for entities that declare crediting rates retrospectively. If there were no restriction, an entity could choose the amount of insurance finance income and expenses recognised in P&L by setting the crediting rate. We considered several approaches:
- (a) prohibiting entities that declare crediting rates retrospectively from applying the projected crediting method;
  - (b) requiring entities that declare crediting rates retrospectively to assume that the rate in the current year is the most recently declared crediting rate (ie the rate declared for the year(s) before); or,
  - (c) requiring entities that declare crediting rates retrospectively to apply the entity's policy to setting crediting rates to the current year (if the entity declares a policy).
16. However, staff expect that amounts credited to policyholders will primarily be driven by economic factors and not a desire to manage reported profits. Also, placing restrictions on amounts assumed to be credited in a period, such as those in sub paragraphs 15(b) and 15(c), would add complexity to the forthcoming Standard and carries a significant risk of causing unintended consequences. For these reasons the staff do not recommend restricting the ability of entities that



declare crediting rates retrospectively to apply a projected crediting method to determining insurance finance expenses in P&L.

17. The staff have also considered whether the Board should constrain the application of the projected crediting method if the expected pattern of crediting over the life of a contract is uneven for reasons other than being based on the expected investment returns from assets the entity holds, or expected market returns. An example of such an uneven pattern is a contract where there is limited crediting compared to expected investment returns in the early years of a contract but a significant bonus credited on maturity or in the later years.
18. However, the staff do not think it is possible to constrain the use of the projected crediting method in a way that is not arbitrary and would not cause significant complexity. Consequently, the staff do not propose to constrain the use of the projected crediting method.

**Question 2. Presentation of insurance finance income or expenses for contracts not eligible for the current period book yield approach**

Does the Board agree:

- (a) that if an entity disaggregates insurance finance income or expenses of a contract for the period between P&L and OCI the Standard should not specify the objective of disaggregating insurance finance income or expenses to present insurance finance income or expenses in P&L on a cost measurement basis;
- (b) to specify that the entity should present in P&L a systematic allocation of the total expected insurance finance or expenses over the life of the contract;
- (c) that the Standard should provide guidance that, in this context, a systematic allocation:
  - (i) is based on characteristics of the contract without reference to factors that do not affect the measurement of the contract. For example, the allocation of the expected finance income or expenses should not be based on expected recognised returns from assets, if those expected recognised returns do not affect the measurement of the fulfilment cash flows; and
  - (ii) results in the amounts recognised in OCI over the life of the contract totalling zero;
- (d) that the Standard should provide further guidance that:
  - (i) for insurance contracts for which changes in financial assumptions do not have a substantial effect on the amounts paid to the policyholder, the systematic allocation is determined using the discount rate(s) applicable at the inception of the contract;

- (ii) for insurance contracts for which changes in financial assumptions have a substantial effect on the amounts paid to the policyholder, a systematic allocation can be determined in different ways, for example:
1. using a rate that allocates the remaining revised expected finance expenses over the remaining life of the contract at a constant rate; or
  2. for contracts that use a crediting rate to determine amounts due to the policyholder, using an allocation that is based on the amounts credited to the policyholder in the period and expected to be credited in future periods.

### ***Disclosures relating to insurance finance income or expenses***

19. The Board's tentative decisions require, inter alia, that an entity disclose:
- (a) insurance finance income or expenses in a way that highlights the relationship between insurance finance income or expenses and the investment return on the related assets that the entity holds;
  - (b) an analysis of the total insurance finance income or expenses recognised in the statement(s) of financial performance disaggregated at a minimum into:
    - (i) the amount of interest accretion determined using current discount rates;
    - (ii) the effect on the measurement of insurance contracts of changes in discount rates in the period;
    - (iii) 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 those insurance contracts, and when measured at current rates; and
  - (c) if an entity disaggregates insurance finance income or expenses presented in P&L and an amount presented in OCI, to disclose an explanation of the methods that the entity uses to calculate the information presented in profit or loss.

20. The requirement in 19(b) was introduced in March 2014 for insurance contracts without participation features and subsequently extended to all insurance contracts to help users of financial statements to:
- (a) compare the effect of changes in discount rates between entities that present the effect of changes in discount rates in profit or loss (P&L) and those that present the effect of such changes in other comprehensive income (OCI); and
  - (b) understand the amount of an entity's total finance income or expenses.
21. The staff think that the analysis of total insurance finance income or expenses described in paragraph 19(b) may not be relevant for all contracts with participation features. For example, it may not be meaningful to break down a change in the current value of estimated cash flows that vary with returns from equity instruments into accretion at a discount rate and the effect of a change in discount rate. The present value of cash flows that vary with returns from equity instruments reflects several inter-related factors, eg, the time value of money, the risk premium the market requires for equity instruments, and the specific market expectation of the entity that issues an equity financial instrument. The staff are not aware of a reliable and practical method to separate the effect of accreting at current discount rates and changes in rates from the other factors.
22. The staff are not aware of an alternative disclosure that meets the objectives noted in paragraph 20. Rather than specify a detailed disclosure that is applicable in some circumstances, but not others, the staff propose to delete the disclosure requirement in paragraph 19(b).
23. Nonetheless, insurance finance income or expenses is likely to have a significant effect on the performance of an insurer – particularly if it issues long duration contracts. Therefore the staff think it is important for an entity to explain
- (a) the total amount of its insurance finance income or expenses in each period;
  - (b) the basis for any disaggregation of the total between amounts recognised in P&L and OCI (consistent with the disclosure requirement noted in paragraph 19(a)); and

- (c) the relationship between insurance finance income or expenses and investment income on the related assets the entity holds (consistent with the disclosure requirement noted in paragraph 19(c)).
24. The staff propose to clarify the purpose of the disclosure in sub paragraph 23(c) by including a specific objective to provide investors with sufficient information for them to understand the sources of net financial income or expenses in the statement of profit or loss and other comprehensive income. The staff would expect entities to discuss, inter alia, investment margins they expect and any significant differences in the nature and duration of assets they hold compared with their insurance contract liabilities.

### Question 3. Disclosure of insurance finance income or expenses

Does the Board agree to:

- (a) Remove the requirement to disclose a specified breakdown of total insurance finance income or expenses
- (b) Include a requirement to explain the total amount of insurance finance income or expenses in a reporting period and combine this with requirements to:
- (i) highlight the relationship between insurance finance income or expenses and investment return on the related assets the entity holds in order to provide investors with sufficient information for them to understand the sources of net financial income or expenses in the statement of profit or loss and other comprehensive income; and
  - (ii) disclose an explanation of the methods that the entity uses to calculate the information presented in P&L.

## Appendix A: Tentative decisions on presentation and disclosure of insurance finance income and expenses

### ***Presentation of insurance finance income and expenses in the statement of profit or loss and other comprehensive income***

- A1. Insurance finance income or expenses is defined as the change in the effect of the time value of money arising from the passage of time and the effect of changes in financial assumptions on the carrying amounts of insurance contracts recognised in the statement of profit or loss and other comprehensive income. Market variables are variables that can be observed in, or derived directly from, markets (for example, prices of publicly traded securities and interest rates).
- A2. Insurance finance income or expenses includes items described in the Exposure Draft *Insurance Contracts* published in 2013 (the 2013 ED) and subsequent redeliberations by the Board as ‘interest expense on insurance liabilities’ but also other items, eg, ‘insurance investment expense’.
- A3. The Board’s tentative decisions require, inter alia, the following in respect of the presentation of insurance finance income or expenses in the statement of profit or loss and other comprehensive income:
- (a) For all insurance contracts (ie, those with and without participation features), an entity:
    - (i) could choose, as its accounting policy, either:
      1. to disaggregate the effect of changes in market variables on the measurement of insurance contracts between profit or loss and OCI; or
      2. to present the insurance finance expenses in profit or loss using a current measurement basis.
    - (ii) should apply that accounting policy to groups of similar contracts, taking into consideration the portfolio in which the contracts are included, the assets that the entity holds and how those assets are accounted for; and
    - (iii) should apply the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to

any changes in that accounting policy [IASB meetings in March 2014, June 2014, July 2014 and September 2015]

- (b) For all insurance contracts, the forthcoming Standard should:
- (i) specify that the objective of disaggregating changes in the insurance contract arising from changes in market variables between profit or loss and other comprehensive income (OCI) is to present an insurance finance income or expenses in profit or loss using a cost measurement basis. Accordingly, an entity recognises in OCI the difference between presenting insurance finance income or expenses in profit or loss using
    1. a cost measurement basis and a current measurement basis, and
    2. the amounts in OCI reverse.
  - (ii) not specify detailed mechanics for the determination of the insurance finance income or expenses using a cost measurement basis (ie the effective yield approach). The Board would provide additional guidance that the mechanics should result in an allocation of the insurance finance income or expenses over the life of the contract on a systematic basis, and would include examples based on paragraph 17 of September 2015 Agenda Paper 2B [September 2015]
- (c) The objective of disaggregating changes in market variables between profit or loss and OCI should be modified for contracts in which there is no economic mismatch between the insurance contract and the related items (for example, the assets and the liabilities) held by the entity. The modified objective would be to present the insurance finance income or expenses that eliminate accounting mismatches in profit or loss between the insurance finance income or expenses and the items held that are measured using a cost measurement basis in profit or loss. The approach that meets the modified objective is referred to as the current period book yield approach. Accordingly, in the current period book yield approach, the difference between the changes in the contract arising from changes in market variables (ie

changes in the fair value of the underlying items) and the insurance finance income or expenses is recognised in OCI.

Economic mismatches do not exist when:

- (i) the contract is a direct participation contract (ie the entity has an obligation to pay the policyholders the fair value of the underlying items and therefore, applies the variable fee approach); and
  - (ii) the entity holds the underlying items, either by choice or because it is required to [September 2015]
- (d) When an entity is required to change between the effective yield approach and the current period book yield approach (and vice versa), the entity shall:
- (i) not restate the opening accumulated balance of OCI;
  - (ii) recognise in profit or loss the accumulated balance of OCI on the date of the change in the period of change and in future periods as follows:
    - 1. when the entity had previously applied the effective yield approach, the entity should recognise the accumulated balance of OCI in profit or loss using an effective yield determined by applying the same assumptions that applied prior to the change; and
    - 2. when the entity had previously applied the current period book yield, the entity should continue to recognise the accumulated balance of OCI in profit or loss using the same assumptions that applied prior to the change.

Those assumptions are subsequently not updated.

- (iii) not restate prior period comparatives; and
- (iv) disclose, in the period that the change in approach occurred:
  - 1. an explanation of:
    - a. the reason for the change; and



- b. the effect of the change on each financial statement line item affected.
  - 2. the value of the contracts that no longer qualified for the current period book yield but previously qualified (and vice versa) [September 2015].
- (e) For all insurance contracts, an entity should present changes in estimates of the amount of cash flows that result from changes in market variables in the same location in the statement of comprehensive income consistently with the changes in discount rates [September 2015].

### ***Disclosures relating to insurance finance income or expenses***

A4. The Board's tentative decisions require, inter alia, the following disclosures in respect of insurance finance income and expenses:

- (a) An entity shall disclose insurance finance income or expenses in a way that highlights the relationship between insurance finance income or expenses and the investment return on the related assets that the entity holds [ED paragraph 82];
- (b) Disclose an analysis of the total insurance finance income or expenses recognised in the statement(s) of financial performance disaggregated at a minimum into:
  - (i) the amount of interest accretion determined using current discount rates;
  - (ii) the effect on the measurement of insurance contracts of changes in discount rates in the period;
  - (iii) 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 those insurance contracts, and when measured at current rates [March 2014 in respect of contracts without participation features and extended in October 2015 to all contracts within the scope of the forthcoming Standard]; and

- (c) If an entity chooses to disaggregate insurance finance income or expenses presented in profit or loss and an amount presented in other comprehensive income, the entity shall disclose an explanation of the methods that the entity uses to calculate the information presented in profit or loss [October 2015].

## Appendix B: Illustrative example of a systematic allocation of insurance finance income or expenses based on crediting rates (projected crediting method)

- B1. Consider a 5 year contract in which a policyholder pays a single premium of CU1,000 at the date of initial recognition ( $t=0$ ). The entity maintains an account balance for the policyholder into which it expects to credit amounts each year at the following rates:

Time	Expected crediting rate in year	Account balance CU	Amount credited in year
0		1,000	
1	2%	1,020	20
2	3%	1,051	31
3	4%	1,093	42
4	5%	1,147	54
5	6%	1,216	69

- B2. The crediting rates reflect an expected increase in market interest rates over the life of the contract. The entity applies a margin of approximately 1% between expected market (forward) rates and the crediting rate it expects to apply each year.
- B3. The entity expects to pay the policyholder CU1,216 at the end of Year 5. The relevant five year market spot interest rate for the contract cash flows at  $t=0$  is 4.84% pa. As a result, the current value of the expected cash outflow and the contractual service margin (CSM) at initial recognition of the contract are CU960 and CU40 respectively.

- B4. Under the proposals noted in paragraphs 13 and 14 of this Agenda Paper, the entity could apply either of the following in order to determine insurance finance expenses in P&L:
- (a) An effective yield to determine insurance finance expenses in P&L (the effective yield at initial recognition is 4.84%); or
  - (b) a series of rates based on the expected crediting rates.
- B5. A series of discount rates based on crediting rates could be calculated as follows:

The product of the expected crediting rates

$$1.02 \times 1.03 \times 1.04 \times 1.05 \times 1.06 = 1.216$$

Adjusting each crediting rate by a constant factor (K) in order that

$$1.02K \times 1.03K \times 1.04K \times 1.05K \times 1.06K = 1,216/960$$

Where  $1,216/960 = 1.2668$

$$K = \sqrt[5]{(1.2668/1.216)} = 1.008198 \text{ (see footnote }^3 \text{ regarding the calculation)}$$

The resulting series of accretion rates for years 1 to 5 are respectively: 2.84%, 3.84%, 4.85%, 5.86% and 6.87%

- B6. Insurance finance expenses recognised in P&L and the carrying amounts of insurance contracts for the purposes of a systematic allocation of total expected insurance finance expenses would be as follows in accordance with effective yield and projected crediting methods.

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<sup>3</sup> The staff are aware that an algebraic solution as shown in the example will not be possible in more complex (and realistic) circumstances – in which case the adjustment factor can only be calculated by iterative calculation methods

Time/year	Effective yield (4.84%)		Projected crediting		
	Carrying amount	P&L finance expenses in year	Annual accretion rate	Carrying amount	P&L finance expenses in year
0	960			960	
1	1,006	46	2.84%	987	27
2	1,055	49	3.84%	1,025	38
3	1,106	51	4.85%	1,075	50
4	1,160	54	5.86%	1,138	63
5	1,216	56	6.87%	1,216	78