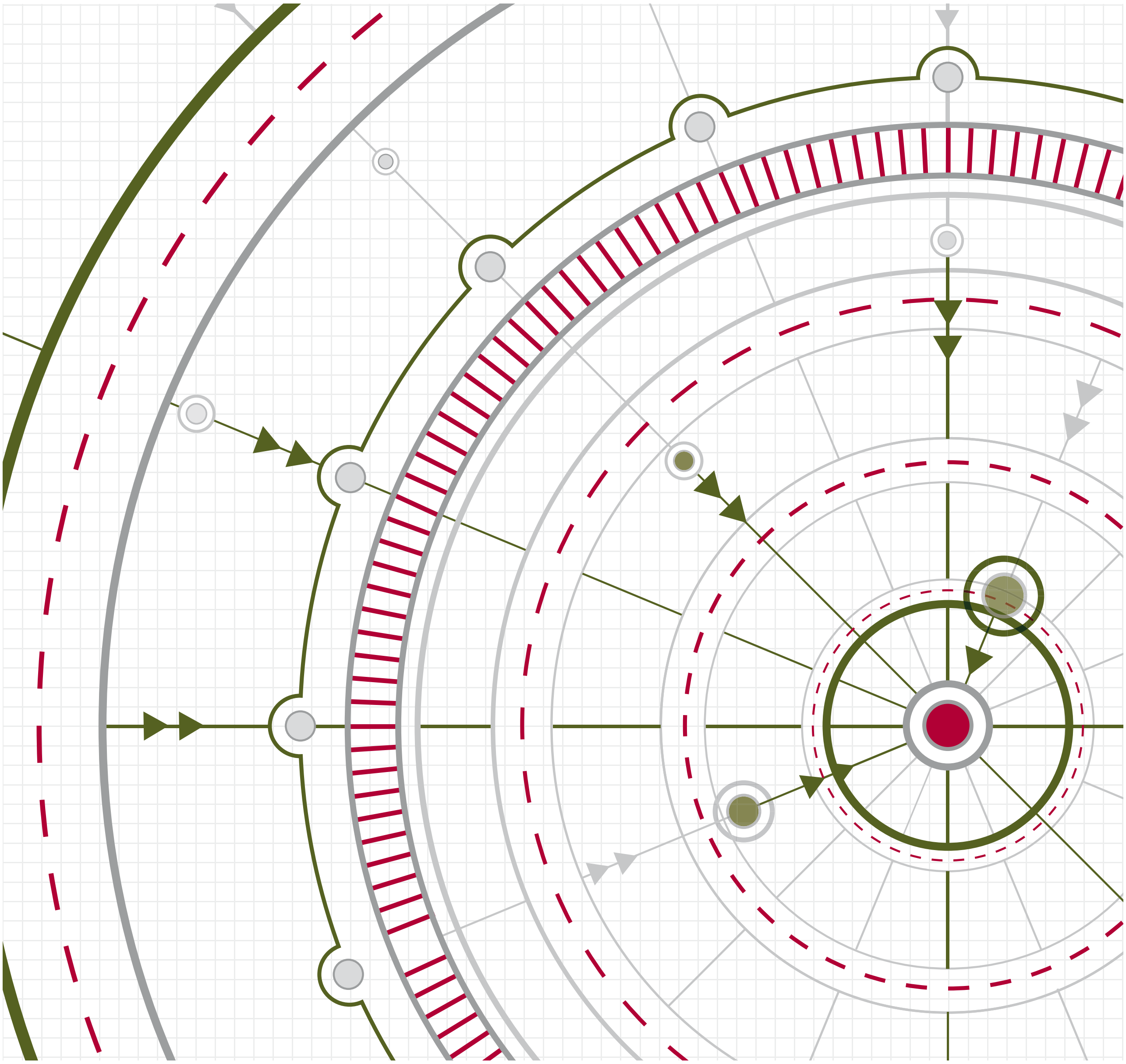
Monday 26 September 2016
The Grange City Hotel (London, UK)

Conference documentation: Insurance Contracts

2016 World Standard-Setters Conference



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World Standard-Setters Conference

Monday 26 and Tuesday 27 September 2016

Education session:
Insurance Contracts

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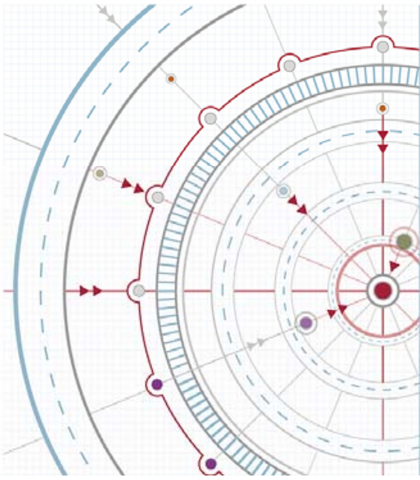

Insurance Contracts Project Update

World Standard Setters, September 2016

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Agenda

- Project status
- The new requirements
- Update on most recent discussions
  - Level of aggregation
  - Mutualisation
  - Variable fee approach
- Likely effects of the new Standard
- Keep up to date

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Project status

Timetable and next steps

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Project Status

1997	2004	2007	2010	2013	Early 2017
IASC starts project on insurance contracts	**IFRS 4 *Insurance Contracts***	**Discussion paper**	**Exposure Draft**	**Exposure Draft**	**Expected publication IFRS 17** *Replaces IFRS 4*

Now

- Topic-based testing
- Drafting process
- Effective date of the new IFRS Standard will be decided in next few months

Early 2017

- Expected publication of IFRS 17

2020-2021

- IFRS financial statements prepared applying new requirements

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The new requirements

Overview

The new approach

- All insurance contracts measured as the sum of:
  - Fulfilment cash flows
    - The present value of probability-weighted expected cash flows
    - Plus an explicit risk adjustment for insurance risk
  - Contractual service margin (CSM)
    - The unearned profit from the contract
- Profit is recognised as insurance services are delivered
- Statement of comprehensive income shows revenue and expenses for insurance services
- Insurance contracts aggregated in groups for measurement

Dealing with volatility

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- Fulfilment cash flows are updated at each reporting date
- Changes in estimates of future cash flows:
  - If related to past coverage → P/L
  - If related to future coverage → adjust unearned profit
    - Unless a group of contracts becomes onerous in which case loss reported in P/L
- Effect of changes in financial market assumptions results in insurance finance expense:
  - Accounting policy choice, ie either:
    - Recognise total insurance finance expense in P/L
    - Disaggregate total insurance finance expense to allocate amounts in P/L over the duration of the contract. Remainder recognised in OCI.

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Simplified approach and variable fee approach

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- Optional simplified 'premium-allocation approach' for short-term contracts
  - Similar outcome but no separate identification of unearned profit (CSM)
  - Discounting of liability for incurred claims not required if expected to be settled within 12 months
- 'Variable fee approach' for 'contracts with direct participation features'
  - The insurers share of income from underlying items adjusts unearned profit
    - Treated as a "variable fee" for investment management services

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Reporting performance

IFRS 4*	New IFRS Standard	Key changes
Premiums	Insurance contract revenue	- Insurance contract revenue excludes deposits - Revenue and expense are recognised as earned or incurred - Insurance finance expense is excluded from insurance service result and is presented (i) fully in P/L or (ii) in P/L and OCI, depending on accounting policy - Written premiums disclosed in the notes
Investment income	Incurred claims and expenses	
Incurred claims and expenses	**Insurance service result**	
Change in insurance contract liabilities	Investment income	
Profit or loss	Insurance finance expense	
	Net financial result	
	Profit or loss	
	Discount rate changes on insurance liability *(optional)*	
	Total comprehensive income	

(*) Common presentation in the statement of comprehensive income in applying IFRS 4

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Disclosures

Amounts	Judgements	Risk
• Expected PV of future payments-receipts • Risk and the contractual service margin • New contracts written in the period • Time value of money (insurance finance expense)	• Estimating inputs and methods • Effects of changes in the methods and inputs used • Reason for change, identifying the type of contracts affected	• Nature and extent of risks arising • Extent of mitigation of risks arises from reinsurance and participation • Quantitative data about exposure to credit, market and liquidity risk

Compared to IFRS 4, additional disclosures relating to the risks and amounts reported in the financial statements

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Transition reliefs

- If some historical data is not available (ie retrospective application is impracticable):
  - Simplified transition approach
  - Fair value approach
  - Disclosures of amounts determined using simplified transition approach or fair value approach, both on transition and in subsequent periods
- Opportunity to reassess the classifications for financial assets under IFRS 9

Update on most recent discussions

Level of aggregation

Level of aggregation—fulfilment cash flows

- Level of aggregation is not relevant for:
  - Determination of fulfilment cash flows
    - Present value is consistently applied irrespective of level of application
  - Determination and allocation of directly attributable expenses
    - Allocation based on nature and 'attribute-ability' of costs
  - Determination and allocation of risk margin
    - Based on entity approach to determining compensation for risk

Level of aggregation is relevant for Contractual Service Margin (CSM)

- CSM is determined as the risk-adjusted present value of the cash inflows and outflows and allocated over entire expected contract life
- CSM depicts the expected profitability of a contract

At inception, if a contract is expected to be…		
…loss making	➡	there is no CSM and a loss is recognised in P/L (onerous contract)
…profit making	➡	CSM is recognised as liability (unearned profit) and is released as insurance services are provided

- Model is asymmetric. This causes differences when contracts are grouped and not grouped

Why aggregate: Example

- An entity issues three contracts. Each contract is expected to have a claim of CU3.5 each year until the contract lapses and each policyholder pays a premium of CU10 at inception
- The entity expects one contract will laps after each year. Thus the expected cash flows are:

Contract expected to last	1 year	2 years	3 years	Total	Average
Premiums	10.0	10.0	10.0	**30.0**	10.0
Expected claims	(3.5)	(7.0)	(10.5)	**(21.0)**	7.0
Profit	6.5	3.0	(0.5)	**9.0**	3.0

- After 1 year:
  - on an individual contract basis, there is a change in expectations for all three contracts
  - on a group basis, there is no change compared to expectations
- Board concluded that contracts need to be grouped

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Objectives for aggregation

- Reflect nature of insurance, which is to aggregate risks
  - Resulting in offsetting of non-economic 'losses'
- Ensure timely information about losses from onerous contracts
- Ensure timely information about losses when previously profitable contracts become onerous
- Ensure that the unearned profits from contracts are recognised when the related service is provided
- Balance loss of information about individual contracts against faithful representation of group

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Why limit aggregation

- Loss of transparency of information
  - Insight into loss-making business activities, cohorts or products
  - Timing of recognition of losses shielded by profitable activities
  - At extreme, losses not recognised until entire entity loss-making
- Potential inconsistency of application
  - Not generally defined in national GAAP or regulatory frameworks
- Consistency within IFRS Standards
  - Revenue, leases and impairment all allow grouping, but only in very limited circumstances
  - Offsetting of onerous contracts against profitable contracts prohibited in absence of contractual link

Determining level of aggregation

- Insurance contracts are aggregated in groups
  - Comparable risks
  - Similar expected profitability
  - Contracts that do not have similar expected profitability, even if as a consequence of regulation, may not be aggregated
- Loss for onerous contracts recognised only when expected losses are greater than expected profits for a group of contracts
  - Within group, net off losses (onerous contracts) and profits (CSM)
- Group not reassessed after inception

Update on most recent discussions

Mutualisation

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Mutualisation

- Mutualisation occurs when one group of policyholders form first layer of risk absorption for another group of policyholders
- Mutualisation requires explicit right of the insurer to act:
  - To the detriment of one group of policyholders
  - To fund losses of another group of policyholders (or vice versa)
- Mutualisation is not:
  - Diversification of risk
  - Cross-subsidisation
  - Discretion

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Mutualisation—fulfilment cash flows

- Expected cash flows between groups of policyholders are part of the fulfilment cash flows
  - Mutualisation inherent in cash flow principles
  - A group of policies is not considered to be onerous if another set of policyholders bears those losses
  - Losses from onerous contracts are only recognised in P/L when no other policyholder has capacity to absorb them
- Level of aggregation for CSM does not affect mutualisation
  - CSM for group is determined after determining fulfilment cash flows, including those from mutualisation
  - Determining the present value of cash flows not dependent on level of aggregation
  - BUT mutualisation may affect level of aggregation

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Mutualisation—level of determination

At inception	
Step 1	• Determine expected cash flows, including cash flows to other policyholders, and cash flows from other policyholders
Step 2	• Determine level of aggregation (comparable risks, similar profitability)
Step 3	• Determine CSM at inception
Subsequently	
• Maintain the level of aggregation (no reassessment) • Remeasure cash flows including cash flows to and from policyholders, and, if they relate to future services, adjust CSM	

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Mutualisation—examples

Example 1—mutualisation between policyholders in same generation sharing same pool of assets

- Two policyholders (A & B) share in same underlying items, but A has higher guarantee
- B shares in residual of underlying after the entity settles A's guarantee
- There is mutualisation between A and B

Example 2—mutualisation across generations

- Returns on underlying assets accumulate, but are not paid out to current generation of policyholders (C)
- Instead accumulated as obligation to future generation (D)
- There is mutualisation between C and D

Mutualisation—examples

Example 3—mutualisation across product lines

- Product E participates in the return on an underlying product line, product F
- In determining the expected cash flows of E, entity must consider cash flows to and from F
- In determining the expected cash flows of F, entity must consider cash flows to and from E

Update on most recent discussions

Variable fee approach

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Variable fee approach—scope

- Contracts with direct participation features
  - Policyholder participates in share of clearly identified pool of underlying assets
  - Entity expects to pay policyholder a substantial share of the return from those underlying assets
  - Cash flows expect to vary substantially with underlying items
- Not all variable contracts qualify for variable fee approach: Variable contracts outside the variable fee approach apply the general model

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Variable fee approach—sensitivity

- Includes any *contract* which creates an obligation linked to underlying items
  - Explicit contractual terms
  - Includes regulatory requirements
- However, measurement based on expected cash flows (not contractually-specified cash flows)
- Obligation is not dependent on holding the underlying assets
- Obligation need not to be current generation of policyholders

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Variable fee approach—mechanics

- Measurement of obligation reflects change in fair value of all underlying items
- Fulfilment cash flow is calculated consistently with the general model
- Difference with general model: changes in the estimate of fee entity expects to earn are adjusted in CSM
  - Fee is equal to entity's expected share of returns on underlying items, less
  - Any expected cash flows that do not vary with the underlying items

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Contrast with general model

Subsequent measurement of the CSM		
	General model	**Variable fee approach**
Changes due to market variables	In P/L or OCI	In CSM (1)
Accretion of interest expense on the CSM	Explicitly using rates at inception	Included in remeasurement

(1) If risk mitigated with derivatives, option to recognise changes in embedded guarantees in insurance contracts in P/L

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Likely effects of the new Standard

Benefits and companies affected

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Benefits of the new requirements

1—Improved comparability

Today wide variety of practices to account for insurance contracts

Issues today	Solution / Benefits
Lack of comparability between insurers • IFRS companies report insurance contracts using different practices **Non-uniform reporting within groups** • Insurance contracts of subsidiaries are consolidated using different practices	• A new framework will replace huge variety of accounting treatments
Inconsistency with other industries • Revenue include deposits • Revenue reported on a cash basis	• Revenue will reflect the services provided, and exclude deposits, like any other industry

Benefits of the new requirements

2—Improved quality of financial information

Today lack of relevant and transparent information

Issues today	Solution / Benefits
Lack of useful information • Use of old or outdated assumptions • Options and guarantees not fully reflected in measurement of insurance contracts • Use of 'expected return on assets held' as discount rate	• Insurance contracts will be measured using current assumptions and will reflect options and guarantees • Discount rate will reflect characteristics of the insurance contract - risks not matched by assets will be reflected in the accounts
Lack of transparency about profitability • Profits recognised on a cash basis • Use of many non-GAAP measures	• The unearned profit will be recognised as the insurance coverage is provided • Additional metrics to evaluate performance will be available

What does this change mean for short-term contracts?

	New requirements	Expected effects
Short-term contracts / Property and casualty	• Simplified approach available for contracts with coverage period of 1 year or less	• No significant change • Need to consider discounting and apply a risk adjustment for incurred claims

What does this change mean for long-term contracts?

	New requirements	Expected effects
Long-term contracts / Life products	• Single accounting model	• Same approach for all products increasing comparability by companies and by jurisdictions
	• Deposit components excluded from P/L	• Insurance contracts with investment components on the same playing field as investment contracts
	• Options and guarantees are reflected in the measurement of contracts	• Current value of insurance contracts reflected in the accounts
	• Estimates are updated regularly	• Actual financial position of insurers (and risks) reflected in the accounts

How will companies be affected?

Multi-national groups applying IFRS Standards	• Harmonisation of accounting policies
Companies issuing long-term / life insurance contracts	• Changes in insurance contract liabilities for companies that did not fully consider (i) options and guarantees (ii) current assumptions • Significant reduction in revenue and expenses for companies that reported premiums as revenue and cash surrenders as expenses
Non-life companies with short-term contacts	• No significant change in revenue • Liabilities for claims discounted • Explicit risk adjustment added

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- Email us:
  insurancecontracts@ifrs.org

Web resources

- Series of webinars April-May 2016
- IASB® *Update*
- Investor resources
- Feedback Statement
- Due process summary
- High-level summary of the project
- Project Update about contracts without participation features

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