IFRS in Focus
IASB re-exposes proposals on insurance contracts accounting

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The Bottom Line

The revised ED confirms the key features of the model exposed in 2010 – requiring a single accounting model for all insurance contracts to be applied at a portfolio level using a current fulfillment value approach that requires an explicit current measurement of expected cash flows and a liability for risk and uncertainty ('building blocks'). This model prohibits the recognition of profit at initial recognition of an insurance contract.

The IASB has modified this model in five ways, under the revised model:

- the component of the liability that represents the unearned profit is adjusted for prospective changes in assumptions ('unlocking');
- interest expense is presented separately between profit or loss and other comprehensive income ('the OCI solution');
- insurance contracts where cash flows are contractually linked to underlying items will use the carrying amounts of these items to account for those cash flows ('the mirroring approach');
- a new definition of insurance revenue and expenses is applied for presentation purposes; and
- a modified full restatement approach is introduced for the first time adoption of the new IFRS.

Comments on the proposals are due by 25 October 2013.

Introduction and background

The IASB insurance contracts project has been running since 1997. With the Financial Accounting Standards Board ('FASB') joining the project in 2008, it has become one of the key projects for convergence between IFRS and U.S. GAAP.

The revised ED ('the 2013 ED') is the latest step in the development of a comprehensive IFRS for insurance contracts.

In 2010 the IASB has published an exposure draft ('the 2010 ED') and the FASB published a discussion paper. The models presented in those documents were similar in many respects, but differed in some key aspects of measuring the insurance liability. Specifically, the explicit measurement of uncertainty surrounding insurance liability estimate and the subsequent recognition of day one unearned profit.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

Those differences have not been fully resolved resulting in two different models. The IASB, in issuing the 2013 ED seeks feedback on the key areas that have been developed since the proposals exposed in 2010. The FASB are in the process of drafting their proposals and are expected to issue an ED shortly.

> Observations
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> While significant progress has been made on developing broadly consistent proposals for insurance contracts under IFRS and U.S. GAAP, understanding the remaining differences will be important for preparers, investors and other users.

What is being re-exposed and why?

The IASB has completed the redeliberations on its 2010 ED and it has decided to seek comments only on the five specific areas of the accounting model where the changes from the 2010 ED have been deemed to be particularly material. These changes are:

- The explicit liability component that captures the unearned profit of an insurance contract ('the contractual service margin') will be adjusted for changes in future expected cash flows relating to future coverage. Although the adjustment for positive changes is unlimited, negative changes cannot create a contractual service margin asset (this approach is termed 'unlocking of the contractual service margin').

- Interest expense will be split in two components:

  - an expense based on the historical discount rates in place at initial recognition will be recognised in profit or loss; whilst

  - the effect of any difference between that rate and the current discount rates used to measure the insurance contracts on the balance sheet will be reported through Other Comprehensive Income (OCI).

  This change is aligned with the introduction of a fair value through OCI measurement model for debt instruments to IFRS 9 *Financial Instruments*.

- Insurance contract cash flows that are contractually linked to underlying items (e.g. assets backing them) will be measured using the carrying amount of those underlying items ('the mirroring approach'). This requirement takes precedence over the OCI solution described above.

- The income statement will show insurance revenue and expenses as amounts derived from the changes in the various components of the insurance liability. Investment components would have to be disaggregated and excluded from the presentation of insurance revenue and expenses. This presentation requirement does not change the impact of the building blocks approach to the insurer's profit or loss.

- Transitional requirements will now require full retrospective application modified with some simplifications in cases where this is impracticable, as defined in IAS 8, to allow restatement of the contractual service margins and the accumulated OCI balance associated with the split of interest expense.

How is this expected to affect insurers?

A far reaching financial reporting change	The ED proposes the introduction for the first time of a single consistent and transparent IFRS for insurance contracts. This will have a material impact on the whole insurance sector that will enjoy for the first time a uniform and comprehensive reporting framework. Consistency and transparency under this new IFRS would provide capital markets with enhanced clarity and comparability around insurers' reporting and could act as an incentive for investors to pay closer attention to the insurance sector.
New profit profiles	The new IFRS focuses on a principle-based approach to the recognition of profits from insurance contracts as the insurer's obligations towards its policyholders are fulfilled. Insurers would need to assess the new profit profiles against those currently reported and prepare to engage with the market to brief all relevant stakeholders about these changes.
New systems would be required	The 'building blocks' approach introduces data that was not previously reported to investors and that requires the application of judgments and estimates against a more consistent and transparent reporting framework. New finance and actuarial systems would be necessary to comply with the new requirements and ensure that speed and accuracy of reporting is maintained post implementation.
Data collection and storage	Significant amount of data would need to be obtained, estimated, stored and tracked to build this model for the first time and to run it thereafter.
Assets-liabilities matching and the new accounting model	On transition and subsequently on the initial recognition of financial assets entities would need to consider the classification and measurement options available under IFRS 9 to faithfully represent any assets-liabilities matching strategy they may have adopted and to reduce accounting mismatches in their financial reports.

What is 'unlocking' the contractual service margin?

The contractual service margin (termed 'the residual margin' in the 2010 ED) was merely the 'day one profit' captured at initial recognition and then released over the coverage period. The 2013 ED proposes to recalibrate prospectively the contractual service margin when assumptions on future cash flows change. This decision reflects the understanding that through recalibration of the margin the insurer would represent more faithfully the prospective emergence of higher or lower profits as a result of a more accurate current estimate of future cash flows.

The 2013 ED requires that the margin is adjusted for changes in estimated cash flows that relate to future insurance coverage or future services to be provided under the contract (e.g. investment management services). Expected increases in future cash outflows relating to future coverage or services would reduce the margin and the amount of profit that can be released in subsequent periods, and vice versa. If the margin is exhausted and the contract becomes onerous, all changes in estimates are recognised in profit or loss as they occur.

This 'unlocking' does not extend to changes in cash flow estimates relating to past coverage, e.g. to claims already incurred. Equally, changes in the uncertainty or riskiness of the cash flows are measured separately by the risk adjustment and flow directly to profit or loss.

As the 'residual building block', the contractual service margin accretes interest in profit or loss at a discount rate locked in at inception in the same way as do the estimates of future cash flows.

The release of the contractual service margin over the coverage period would be on a systematic basis that is consistent with the pattern of transfer of services provided. The 2013 ED does not specify the level of aggregation required for amortisation of the margin, other than to say that the level should be sufficient to determine that all margin has been released to profit or loss by the end of the coverage period.

Observations

The decision to introduce the unlocking would appear to be in line with the economics of insurance. However, the decision to derecognise the contractual service margin over the coverage period or earlier would potentially produce asymmetry in profit or loss between the recognition of profit and the pattern of release from risk that would always extend post-coverage. For insurance contracts with a short claims settlement period, such as a standard life policy, the impact may be minimal. However, for other products with a short contract term and a long claims settlement period (e.g. annual product liability policy) the impact is likely to be much greater.

In the context of 'open portfolios' where new contracts are added continuously, the insurer would need to group contracts based on contract terms (period of initial recognition, duration of coverage and shape of the earning pattern) and ensure that their operating systems are capable of tracking the release of the contractual service margin over the coverage period.

What is the 'OCI solution' for interest expense?

All estimates of future cash flows under the 'building block' approach would need to be discounted (unless the effect of discounting would be immaterial). The discount rate to be applied is, therefore, one of the most material estimation factors. Under the proposals of the 2010 ED, any changes to discount rates would have flowed through to profit or loss. Given the significant level of insurance liabilities and financial assets backing them that are sensitive to market interest rates, respondents to the 2010 ED identified that this could result in the view of an insurer's performance being distorted by the effect of short-term fluctuations in market interest rates.

To address this problem the IASB has developed an 'OCI solution' designed to work in conjunction with the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9 (Proposed amendments to IFRS 9 (2010))*.

The 'OCI solution' is to show both types of information considered valuable to users: a current liability value and a historical cost-based interest expense. Under the proposed approach, the statement of financial position would always show a current measure of insurance liability. The income statement, on the other hand, would reflect the historical time value of money locked in at inception.

Changes in discount rates would be reflected in OCI and would reverse over time as insurance liabilities are fulfilled. If the insurance liability is derecognised (e.g. on sale of a portfolio) the amounts deferred in OCI would be 'recycled' to profit or loss. At the same time, under the IFRS 9 ED proposals (and the equivalent U.S. GAAP ED) insurers would also be able to reflect fair value changes of certain debt-like instruments through OCI.

Insurers traditionally manage the time value risk of their long term insurance liabilities through duration matching of the investment bonds they hold. The IFRS 9 ED proposals would apply to debt-like financial instruments meeting the contractual characteristics test of that standard (e.g. bonds) and which are managed both for collection of contractual cash flows and for sale. The intended effect of these decisions would be to reduce short-term volatility in profit or loss and to minimise accounting mismatches in presenting performance of asset-liability management.

The 'OCI solution' is proposed to be mandatory for insurance liabilities. Similarly, on the asset side, the OCI remeasurement of fair value is proposed to be mandatory for financial assets that meet both contractual cash flow characteristics and business model tests under IFRS 9.

Observations

The 2013 ED introduces 'the OCI solution' as a requirement for all insurance contracts while the IFRS 9 proposed amendments depend on the relevant tests set out in the Exposure Draft noted above. In addition, assets-liabilities matching strategies may use derivative financial instruments to achieve a matching of cash flows for very long liability durations. Derivatives are only accounted for at fair value through profit or loss thus leaving insurers to deal with a remaining accounting mismatch if they have actively mitigated with derivatives the different durations of their insurance liabilities and non-derivative financial assets.

On the other hand, where an insurer holds financial assets with shorter durations than those of its insurance liabilities the effect of this duration mismatch would be reflected entirely in OCI.

To understand the insurer's assets-liabilities management strategy users would need to consider both parts of the statement of comprehensive income.

How does the model apply to contracts where cash flows vary with underlying items (the mirroring approach)?

Different types of insurance contracts have cash flows that vary with the returns on underlying items either through a contractually specified link or indirectly. These are typically referred to as 'participating', 'with-profits', 'unit-linked', 'index-linked', 'universal-life' type contracts along with many other variants.

To respond to the issue of accounting mismatch between insurance liabilities and the assets backing them the 2013 ED introduces a new requirement applicable to those cash flows in an insurance contract that vary with underlying items.

The new requirement applies to different types of linkage:

Type of contractual linkage	Accounting treatment under the 2013 ED
Insurance contracts that specify a direct contractual link and require an insurer to hold underlying items (e.g. 'unit-linked' contracts)	Linked cash flows' measurement and presentation is determined by the measurement and presentation of the underlying items (even if they are on a non-current basis). This is referred to as a 'mirroring approach'. The 'mirroring approach' overrides other requirements of the 'building blocks' model including those from the 'OCI solution'. To the extent that a direct link exists the 'mirroring approach' eliminates accounting mismatches in measurement and presentation.
Insurance contracts that specify an indirect contractual link and require an insurer to hold the underlying items (e.g. embedded options and guarantees)	When insurance contracts offer protection from the downside risk or allow direct participation only in the upside risks of referenced underlying items held, the link to the returns of the underlying items is indirect. When these features are not unbundled they are measured using the general 'building blocks' model. However, changes in the estimated future cash flows would be reflected in profit or loss using current discount rates. In other words, the 'OCI solution' would not apply to such cash flows.
Insurance contracts that either do not specify a contractual link or requirement to hold underlying items but have cash flow variability based on the underlying items	These types of contracts allow insurer's discretion in allocating returns to the policyholder accounts and there is no requirement for an insurer to hold the underlying items (e.g. index-linked contracts). The measurement of the estimated future cash flows would use the general 'building blocks' model. In presenting the interest expense in profit or loss the 'OCI solution' is modified. The discount rate determined at inception for the presentation of the interest expense is reset whenever the returns on the underlying items are expected to affect estimated future cash flows. The interest expense on those cash flows would be similar to that of a variable rate financial liability. The difference between this reset rate and current discount rates would be recognised in OCI.

In all of these contracts when there are also other cash flows that do not vary with underlying items, the general 'building blocks' approach is utilised.

Observations

- The IASB proposal aims to reduce accounting mismatches for certain types of contracts (e.g. 'unit-linked').
- An analysis is required of the different types of cash flows within a single product, which can be complex.
- Products with embedded options, minimum guarantees and other cash flows that vary indirectly with underlying items have both the changes in estimates and discount rate for such cash flows reflected in profit or loss (no OCI solution is available).

How is the new insurance revenue defined?

The 2013 ED confirmed the approach that views the whole insurance contract as one item, with a single balance capturing all fulfillment cash flows and performance obligations resulting from the contract.

For profit or loss, the 2013 ED introduces a new definition of insurance revenue that attempts to respond to investors' demand for a prominent revenue figure that was as consistent as possible with revenue reported in other industries.

For short term contracts applying the premium allocation approach, revenue amounts are generated automatically on amortising the premium thus requiring a new proposal only for the insurance contracts under the general 'building blocks' approach.

The new definition of insurance revenue is based on an approach that derives the revenue amount from disaggregating the change in the liability calculated using the 'building blocks'.

The revenue amount reflects the insurer's progress in satisfying the obligation to provide insurance coverage and other services and is recognised over the coverage period. It is defined as the sum of the change in the risk adjustment for cash flows associated with future coverage, the release of the contractual service margin and the amount for expected claims and benefits for the period.

Change in risk adjustment for future coverage + Release of contractual service margin + Expected claims and benefits for the period = Insurance Revenue

Actual claims, benefits and expenses incurred in the period will be presented in the insurance expenses line. In substance, the IASB has attempted to separate the experience variances line item that was introduced in the summarised margin presentation proposed in the 2010 ED into revenue and cost components.

Many long term policies contain investment elements that are not unbundled and treated as separate contracts because they are not 'distinct'. To be distinct, a contract must be not highly interrelated and a contract with equivalent terms must be sold or could be sold separately in the same market or same jurisdiction by insurers or other parties. The 2013 ED requires that these deposit amounts are disaggregated and excluded from the amounts of insurance revenue and expenses. These investment components are defined as an amount that the insurer is obligated to pay a policyholder or a beneficiary regardless of whether an insured event occurs.

For contracts specifying a direct contractual link to the returns of the underlying items held, presentation and measurement follow the 'mirroring approach' and changes in an insurance liability follow the presentation of changes in underlying items.

Observations

The insurance revenue figure reported in profit or loss would most likely not correspond to the amount of premium received in the period. Neither would it reflect the amount of new business written. Entities may want to engage with their investors, analysts and other users to educate them on this matter.

Transition, effective date and comment period

The 2013 ED proposes to allow preparers approximately three years from the date of the standard being published to the date of mandatory implementation. Early application would be permitted and the entity would be required to restate comparatives. Given the significant accounting changes proposed, three years may be needed to assess the impacts of the ED on their business and to prepare. There would be a need to review systems, streamline operating and reporting processes, organise data capturing, processing and storage, train staff and effectively communicate with key stakeholders.

The standard will apply retrospectively with requirement to make maximum use of objective data. This means that on transition entities would have a current measure of their insurance liabilities still outstanding which would include a contractual service margin to the extent that the coverage period has not yet expired. The impact of changes in the time value of money from inception of contracts to the transition date would be reflected in accumulated OCI. This would allow comparability across time and between products that were entered before and after transition.

To facilitate transition, the IASB has proposed a number of simplifications for estimating expected cash flows, discount rate, risk adjustment and contractual service margin in situations where a normal restatement approach may prove impracticable.

Item to be restated	Modified restatement approach
Expected cash flows at initial recognition	When retrospective application is impracticable an insurer is required to assume that all subsequent changes in cash flows were known in advance at the date of initial recognition and restate prior periods with the benefit of hindsight.
Discount rate at inception	The yield curves at transition that would be 'locked in' for the purpose of calculating interest expense in profit or loss are determined as follows: • if there is an observable yield curve that approximates the yield curve that would have been applied in accordance with the standard for at least three years before the date of transition, the insurer would be required to use that observable yield curve; or • if the yield curve described above does not exist, the insurer would be required to apply a spread (averaged over at least three years if possible) between an observable yield curve that most closely approximates the yield curve that would have been applied in accordance with the standard, and that yield curve as it would have been determined in accordance with the requirements of the standard. The resulting yield curve would be used to determine all the necessary discount rates and determine the contractual service margin on initial recognition. Entities would use the various discount rates for recognising interest expense on the liability. The cumulative effect of the difference between those rates and the discount rates determined at the transition date would be recognised in OCI.
Risk adjustment	Insurers would need to assume that the risk adjustment determined at initial recognition is the same as the risk adjustment detemined on the date of transition.
Contractual service margin	Once the other 'building blocks' above have been calculated, the insurer would be able to estimate the contractual service margin at initial recognition. For contracts with remaining coverage at the date of transition insurers would need to determine the portion of contractual service margin that relate to future coverage/service with the difference recognised in retained earnings.
Designation of financial assets	On transition, insurers would be able to re-designate their financial assets at fair value through profit or loss (FVTPL) if that would eliminate or significantly reduce an accounting mismatch. Where insurers have previously designated financial assets at FVTPL because it reduced an accounting mismatch and such mismatch no longer exists as result of the application of the 2013 ED, such designations would need to be revoked. Entities that have already applied IFRS 9 on transition would be able to re-designate certain equity instruments not held for trading as at fair value through OCI or to revoke such designations.

Observations

On transition insurers would need to review their financial asset classifications to ensure that these are appropriate and best reflect the insurer's assets-liabilities management. In particular, entities would need to ensure that assets designated at FVTPL continue to eliminate accounting mismatches or they would have to be reclassified.

Comments on the 2013 ED are due by 25 October 2013.

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Designed and produced by The Creative Studio at Deloitte, London. 27701A