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# IFRS-FA – öffentliche SITZUNGSUNTERLAGE

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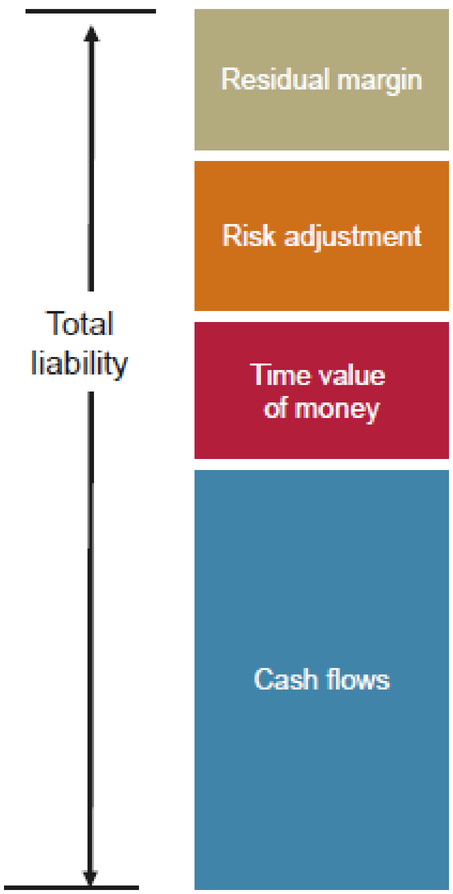
|---|---|
| Sitzung: | 9. IFRS-FA / 20.09.2012 / 09:30 – 11:30 Uhr |
| TOP: | 01 – Insurance Contracts |
| Thema: | Stand des IASB Projekts |
| Papier: | 09_01a_IFRS-FA_Insurance Contracts |

# Agenda

1. **Recap of the accounting model**
2. Recent IASB discussions
3. Remaining Issues
4. Next steps IASB
5. Next steps DRSC

# 1. Recap of the accounting model

## *Building Block Approach*




Quantifies the unearned profit the insurer expects to earn as it fulfils the contract

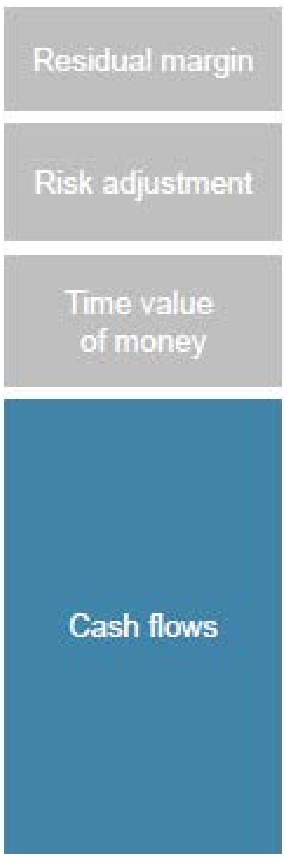
Quantifies the difference between the certain and uncertain liability

An adjustment that reflects the time value of money

The amounts the insurer expects to collect from premiums and pay out as it acquires, services and settles the contract, estimated using up-to-date information

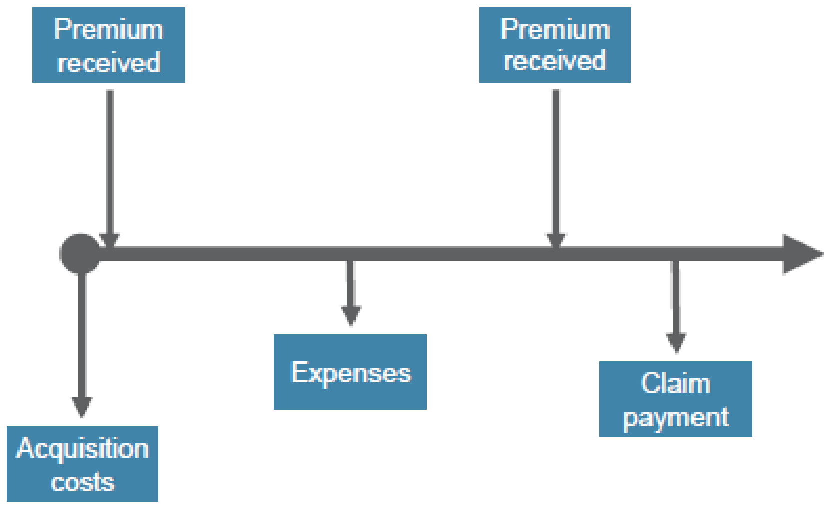
# 1. Recap of the accounting model

## *Building Block Approach*




**Cash Flows:**

An explicit, unbiased and probability-weighted estimate of the future cash outflows (less the future cash inflows) that will arise as the insurer fulfils the insurance contract




**Included in cash flows:**

All direct costs of originating and all directly attributable costs incurred in fulfilling a portfolio of insurance contracts

# 1. Recap of the accounting model

## *Building Block Approach*

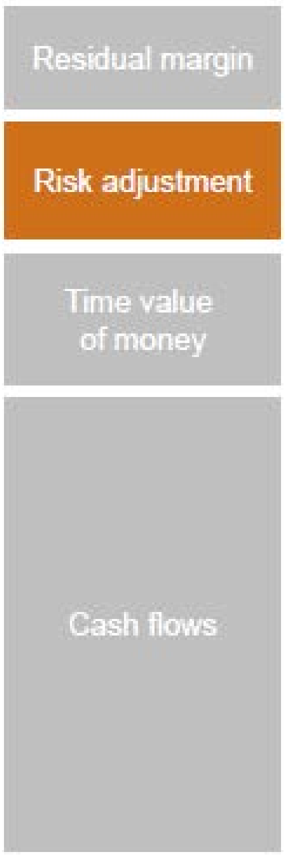

**Time value of money:**

A discount rate that adjusts cash flows for the time value of money

**Tentative decisions:**

- Reflects only the characteristics of the insurance contract liability
- Current and updated each reporting period
- Add guidance:
  - Do not describe method: ‘Top-down’ and ‘bottom-up’ both acceptable
  - Remove any factors that influence observable rates not relevant to the liability

# 1. Recap of the accounting model
## *Building Block Approach*




**Risk adjustment :**

•An explicit estimate of the effects of uncertainty about the amount and timing of future cash flows

•The compensation the insurer requires to bear the risk that the ultimate cash flows could exceed those expected

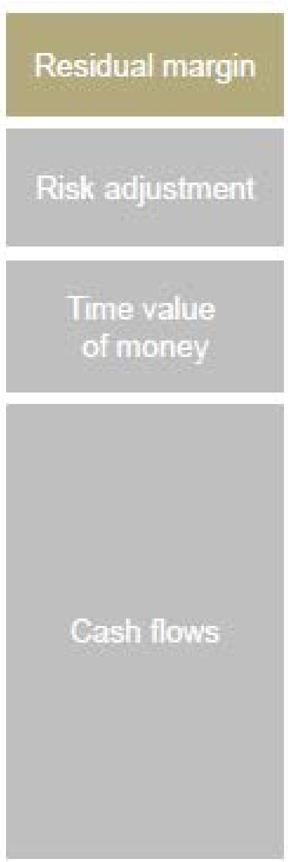
**Tentative decisions:**

•Measurement of liability should include explicit risk adjustment

•No restriction on permitted techniques

•Disclose confidence level equivalent

# 1. Recap of the accounting model
## *Building Block Approach*




**Residual margin :**

A residual margin that quantifies the unearned profit the insurer expects to earn as it fulfils the contract

**Tentative decisions:**

- Unit of account: portfolio
- No gain at inception
- Adjust residual margin prospectively for changes in estimates of cash flows (unlocking)
- Do not unlock for changes in risk adjustment
- Residual margin allocated:
  - over coverage period
  - on a systematic basis that is consistent with the pattern of transfer of the services provided

**To be determined (see chapter 3):**

- Allocation of residual margin after change in estimates
- Whether to accrete interest on residual margin

# 1. Recap of the accounting model
## *Premium Allocation Approach*

Premium-allocation approach


Building block approach


**Simplified way of measuring the insurer's obligation to pay for future insured events covered by existing contracts**

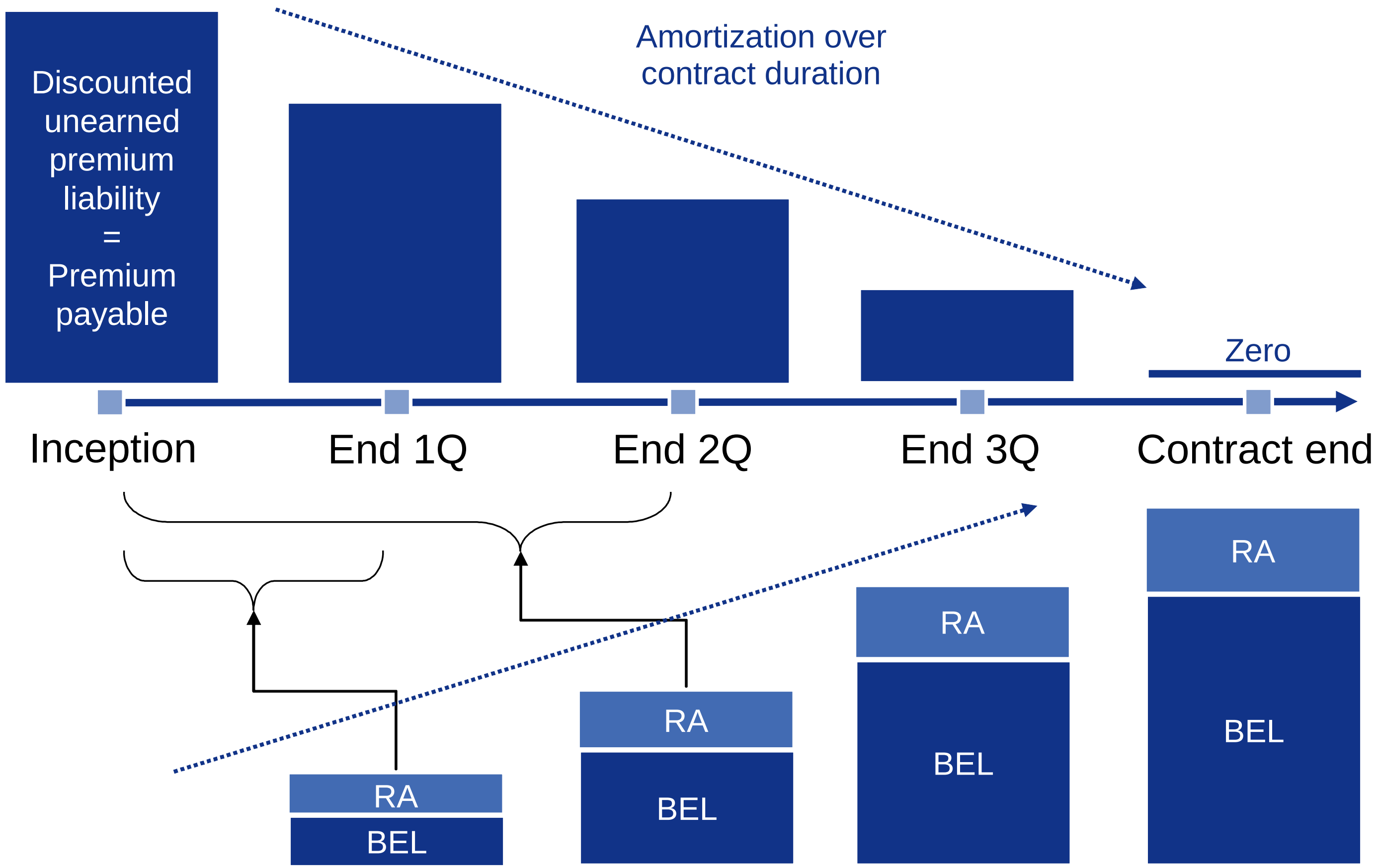
- On initial recognition, measure the <u>liability for remaining coverage</u> at the present value of the premiums received and receivable under the contract, less acquisition costs. Reduce the liability for remaining coverage over the coverage period on the basis of the passage of time.
- Recognise an <u>additional liability if a contract is onerous</u>. That liability would be measured at the excess of the present value of the fulfilment cash flows relating to future claims over the carrying amount of the liability for remaining coverage.
- The insurer's <u>obligation to pay claims for insured events that have already occurred</u> is measured using the standard measurement requirement (i.e. the Building Block Approach).

# 1. Recap of the accounting model
## *Premium Allocation Approach*

- **Permitted** if reasonable approximation to the Building Block Approach:
  - Coverage period is 12 months or less, or
  - Both following apply:
    - No significant changes in estimates are likely to occur before the claims incur, and
    - No significant judgement needed to allocate premium.

- **Tentative decisions:**
  - Reflect time value of money if financing element is significant.
  - No discounting required when period between payment and satisfying obligation shorter than 12 months.
  - Onerous contract test when facts and circumstances indicate contract might be onerous.
  - Liability for incurred claims: no discounting required if claims expected to be settled within 12 months.

# 1. Recap of the accounting model
## *Premium Allocation Approach*




**RA** = Risk adjustment
**BEL** = Best estimate liability

# Agenda

1. Recap of the accounting model
2. **Recent IASB discussions**
3. Remaining Issues
4. Next steps IASB
5. Next steps DRSC

# 2. Recent IASB discussions
***April-July 2012***

- Acquisition costs in the Building Block Approach
- Risk adjustment and residual margin
- Policy loans
- Method of measuring earned premiums
- Contract modifications (including riders)
- Reinsurance
- Unbundling of non-insurance components
- Use of OCI

# 2. Recent IASB discussions

| | |
|---|---|
| **Acquisition costs in the Building Block Approach** | •Included in the cash flows used to determine the margin.<br>•No separate deferred acquisition cost (DAC) asset. |
| **Risk adjustment and residual margin** | **Confirmed:**<br>•The measurement of an insurance contract should include an updated, explicit risk adjustment.<br>•Changes in estimates of future cash flows should be offset in the residual margin.<br>•Other changes in estimates should not be offset in the residual margin. |
| **Policy loans** | •Policy loans should be considered in determining the amount of the investment component to which they relate. |
| **Method of measuring earned premiums** | •The board agreed to explore further the usefulness of the information and the extent of any operational difficulties. |

# 2. Recent IASB discussions

## *Contract modifications (including riders)*

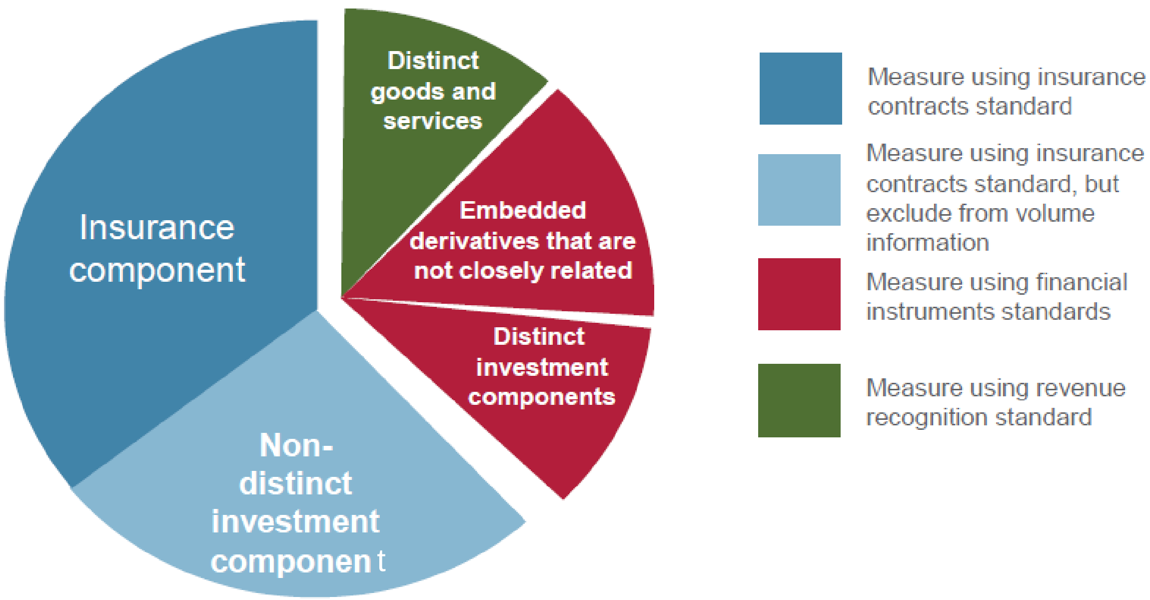
- An insurer should derecognise an existing contract and recognise a new contract if it amends the contract in a way that would have resulted in:
  - a different assessment of either of the following items had the amended terms been in place at the inception of the contract.
  - the contract being included in a different portfolio than the one in which it was included in at initial recognition.
- When an insurer makes a substantial modification to an insurance contract, the gain or loss on extinguishment of the original contract should be determined by measuring the existing insurance contract using the current entity-specific price that the insurer would hypothetically charge the policyholder for a contract equivalent to the newly recognised insurance contract.
- Insurers should account for non-substantial modifications as follows:
  - If the modification eliminates the insurer's obligation to provide some of the benefits that the contract would previously have required, the insurer shall derecognise that portion of its obligation (including any related portion of the residual/single margin).
  - If the modification entitles the policyholder to further benefits, the insurer shall treat the modification as if the amendment was a new standalone contract.

# 2. Recent IASB discussions
## *Reinsurance*

- For retroactive reinsurance contracts, the residual or single margin included in the cedant's reinsurance recoverable and the reinsurer's insurance contract liability should be amortised over the remaining settlement period in the same manner as the release of the single/residual margin (in line with the pattern of services (for the IASB)
- Both the cedant and the reinsurer should evaluate whether to account for the reinsurance contract using the building block approach (BBA) or the premium allocation approach (PAA) in the same manner in which an insurer should evaluate a direct insurance contract. Included in the cash flows used to determine the margin.
- The cedant should account for a reinsurance contract using the same approach (building block approach or premium allocation approach) that the cedant uses to account for the underlying direct insurance contracts.

# 2. Recent IASB discussions
## *Unbundling of non-insurance components*

- An investment component or embedded derivative shall be measured as if it had been issued as a separate contract (Attribution of cash flows on a stand-alone basis).
- No application of revenue recognition or financial instrument standards to components of an insurance contract when unbundling is not required.



# 2. Recent IASB discussions
## *Use of OCI*

**Arguments for use of OCI:**

- Accounting mismatches are reduced (assuming that assets are also measured at FV OCI).
- Short-term movements in the discount rate do not affect P&L reflecting the long term nature of insurance (the discount rate effects reverse over time – other assumptions do not).
- Underwriting results are not overshadowed by market movements and continue to be reported in P&L.
- Information about economic mismatches (duration / options and guarantees) are presented in a transparent manner in OCI**.**

# 2. Recent IASB discussions
## *Use of OCI*

**Arguments against use of OCI:**

- Economic mismatches arising from duration mismatches / credit spreads / options and guarantees are presented in OCI rather than P&L: some argue that this is less transparent.
- Presenting all changes in P&L is less complex for both users and preparers.
- Accounting mismatches arise in profit or loss for assets at FVPL / in equity for assets measured at cost (in case OCI is mandatory).
- Macro-hedge accounting might solve the volatility issue.

# 2. Recent IASB discussions
## *Use of OCI*

| **Basic questions** | **Tentative IASB decisions** |
|---|---|
| Should the use of OCI be permitted or required? | •Presentation of changes in the insurance liability arising from changes in the discount rate in OCI is required.<br>•Presentation in interest expense using the discount rate locked in at inception of the insurance contract. |
| Should changes in the insurance liability arising from changes in interest rate sensitive cash flow assumptions be presented in OCI? (e.g. embedded interest rate guarantees, lapse assumptions) | Changes in the insurance liability arising from changes in interest sensitive cash flow assumptions should not be presented in OCI. |
| If expected cash flows increase, what discount rate should be applied in P&L: The discount rate at inception or the current discount rate at the date the assumption changes? | The discount rate locked in at inception of the insurance contract will be applied to changes in expected cash flows. |
| Should there be a loss recognition test (LRT)? | No LRT included in the board’s proposed requirements |

# 2. Recent IASB discussions

## *Use of OCI: FVOCI measurement category for eligible debt instruments*

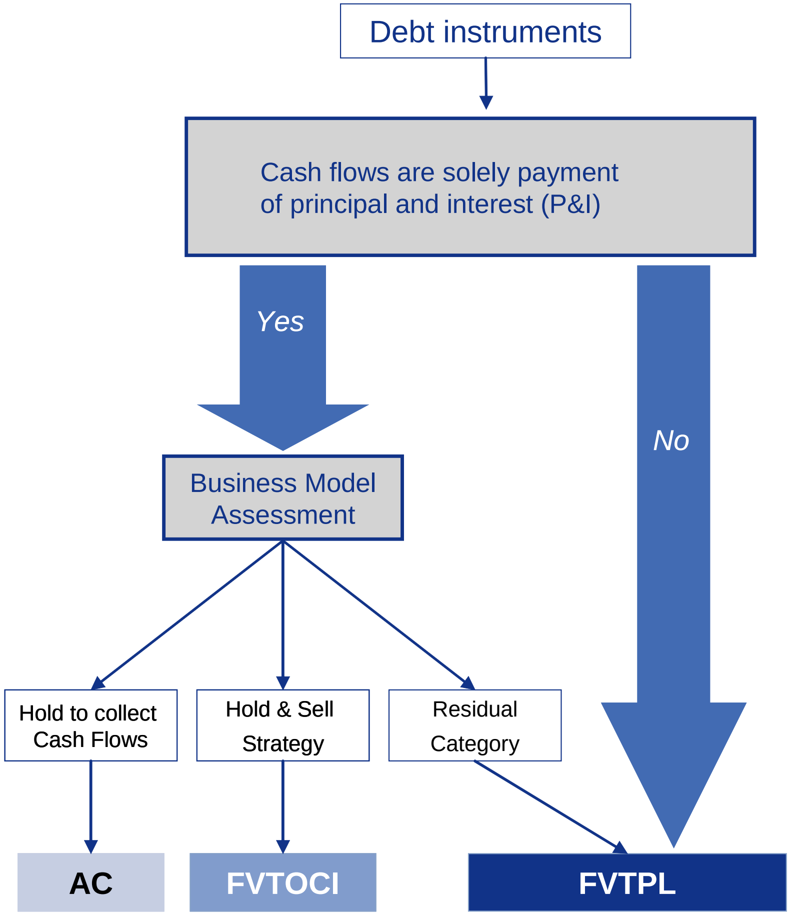
**Tentative decisions:**

•An FVOCI measurement category for eligible debt instruments shall be added to IFRS 9.

- Fair value changes are recognised in OCI.
- Effective interest rate method, i.e. interest payments are recognised as income.
- Recycling of amounts from OCI to P&L in case of sale.
- Recognition of credit impairment losses / reversals in P&L.

•A debt instrument will be measured at FVOCI only if:

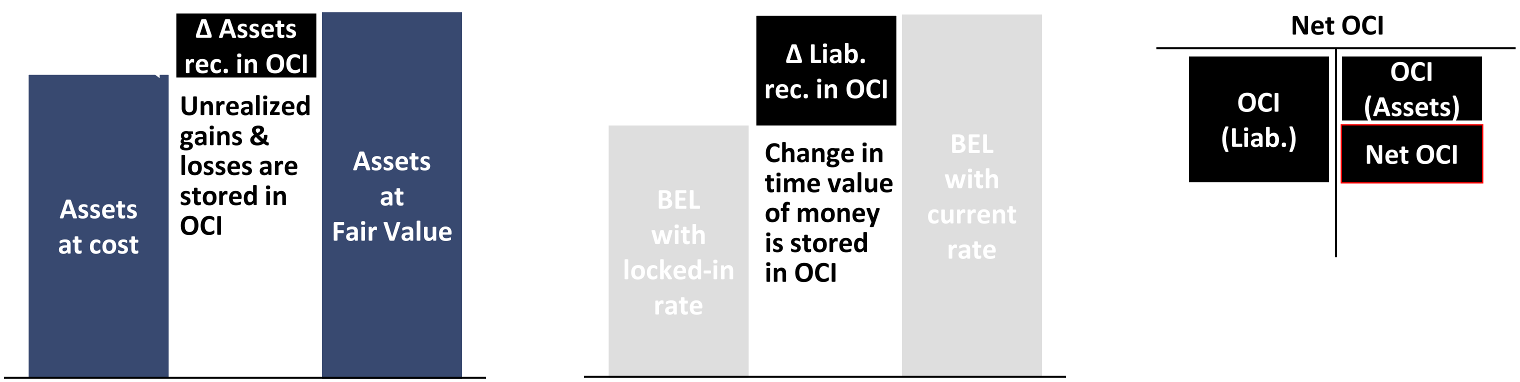
- the debt instrument passes the contractual cash flow characteristics assessment, and
- the debt instrument is managed within the relevant business model.



# 2. Recent IASB discussions

## *Use of OCI*

- Consistency with accounting treatment of prepayment cash flows for a debt instrument that is measured at FVOCI.
- Short-term fluctuations for both assets and liabilities are recognized in OCI




$$\text{Amount of Liability OCI}_{\text{accumulated}} = \text{Liability}_{\text{locked-in(t)}} - \text{Liability}_{\text{current(t)}}$$

$$\text{Amount of Asset OCI}_{\text{accumulated}} = \text{Asset}_{\text{Fair Value (t)}} - \text{Asset}_{\text{Cost (t)}}$$

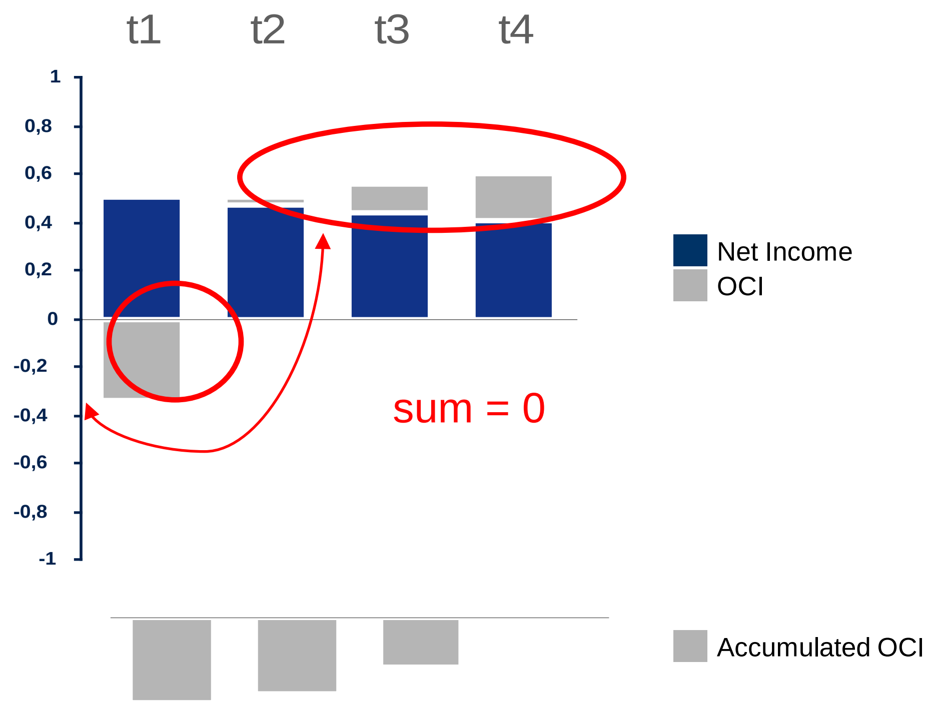
**The application to participating insurance contracts still remains open.**

# 2. Recent IASB discussions
## *Use of OCI: net income & OCI pattern*

- OCI will be zero at contract maturity, as all differences in the time value of money disappear at contract maturity as the discount effect will be zero by definition

- Stable net income and **no recycling mechanism for OCI needed**

<u>Example:</u> $i_{t=0}$ = 5,0%; $i_{t=1,2,3,4}$ = 3,5%



# Agenda

1. Recap of the accounting model
2. Recent IASB discussions
3. **Remaining Issues**
4. Next steps IASB
5. Next steps DRSC

# 3. Remaining Issues

- Volume information
- Residual margin
- Disclosures
- Participating contracts
- Transition

# 3. Remaining Issues
## *Volume information*

### To be determined:

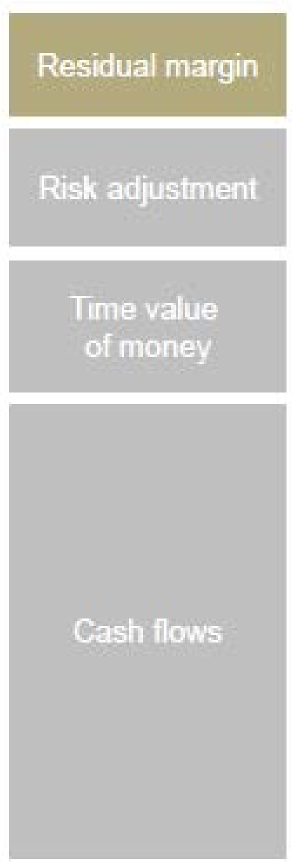
The board has yet to determine the amount of premiums presented in each accounting period

### Tentative decisions:

•Volume information on face of statement of comprehensive income
•Exclude investment components from premiums presented on face of statement of comprehensive income
•Present in OCI changes in the insurance liability arising from changes in the discount rate

| | 20XX |
|---|---|
| Premiums* | X |
| Changes in insurance liability | X |
| Claims and expenses | (X) |
| Underwriting result | X |
| Investment income | X |
| Interest on insurance liability, based on locked in discount rate | X |
| Net interest and investment | X |
| Profit or loss | X |
| Effect of discount rate changes in insurance contract liability | X |
| Total comprehensive income | X |

# 3. Remaining Issues
## *Residual margin*




**Tentative decisions:**

- Unit of account: portfolio
- No gain at inception
- Adjust residual margin prospectively for changes in estimates of cash flows (unlocking)
- Do not unlock for changes in risk adjustment
- Residual margin allocated:
  - over coverage period
  - on a systematic basis that is consistent with the pattern of transfer of the services provided

**To be determined:**

- Allocation of residual margin after change in estimates
- Whether to accrete interest on residual margin

# 3. Remaining Issues

## *Residual margin: FASB proposes Single Margin approach*

| Topic | IASB view | FASB view |
|---|---|---|
| **Risk adjustment** | Risk:<br>•explicitly determined<br>•remeasured each period through P&L | Risk:<br>•included implicitly in single margin<br>•not remeasured over the contract term |
| **Residual/single margin** | •Released over the coverage period based on pattern of service<br>•Changes in estimates of future cash flows offset in the measurement of the residual margin | •For BBA: released over the coverage and settlement period based on the release from risk<br>•For PAA: released over the coverage period only, based on release from risk<br>•All changes in cash flow estimates recognised in P&L |

# 3. Remaining Issues
## *Disclosures*

**Tentative decisions:**

•Methods and inputs used to derive estimated values

•Effect of changes in estimates

•The effects of risks arising from insurance contracts, including sensitivity analysis

•Maturity analysis of cash flows

**To be determined:**

•Level of aggregation in the reconciliation of changes in insurance liability

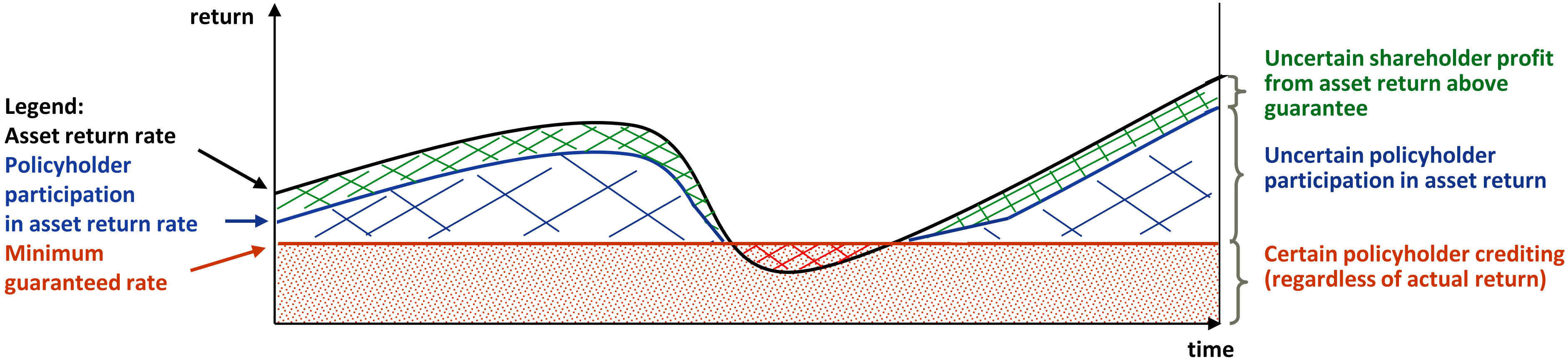
•Disclosures relating to unlocked residual margin, participating contracts and use of OCI

•Interim disclosures

# 3. Remaining Issues
## *Participating contracts: definition*

- Participating contracts or contracts with discretionary participation features include all those policies whose policyholders have a right to receive, as a supplement to guaranteed benefits, additional benefits.
- Participating insurance contract liability cash flows generally depend on asset returns.
- Profitability for the shareholder also depends on the mechanism of sharing (asset) returns between the policyholder and the shareholder.

**European 90/10 par contract with minimum guarantee**



# 3. Remaining Issues
## *Participating contracts: IASB decisions*

**Tentative decisions:**

- Discount rate reflects dependence of cash flows on specific assets.
- Adjust cash flows to reflect the measurement basis of the items underlying participation.
- Present of changes in estimates consistently with equivalent changes in underlying item (**“mirroring approach”**).

# 3. Remaining Issues
## *Participating contracts*

**Does the tentative decision for OCI also work for participating contracts?**

- Industry raises concerns due to the significant dependency of liabilities on asset returns.
- Instead of using a locked-in interest rate, the industry proposes to use a current portfolio book yield incl. current assumptions on reinvestment rates.
- Expected returns are relevant for the profitability of a contract for both the policyholder and the shareholder; if they change, the residual margin should change: residual margin should be unlocked for financial assumptions as well for participating contracts.

# 3. Remaining Issues
## *Participating contracts*

### Suggestion of the industry: Current/Current/OCI with a floating residual margin

- The Best Estimate Liability (BEL) is presented in the balance sheet on a current market rate basis.
- The difference between the BEL at current portfolio book yield and the BEL at current market rate is recognised in OCI.
- The unwind of the BEL at current portfolio book yield is recognised in the P&L account.
- Changes in the BEL as a result of changes in the current portfolio book yield may be offset by a change in the residual margin as these are in essence changes in estimated profits that are deferred and recognised over the life of the contract (**“floating” residual margin**).

# Agenda

1. Recap of the accounting model
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4. **Next steps IASB**
5. Next steps DRSC

# 4. Next steps IASB

## Project milestones


Source: http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Insurance-Contracts.aspx

- The IASB expects to publish a review draft or a revised ED end of 2012.
- The FASB expects to publish an exposure draft end of 2012.
- The final standard will not be effective before 1 January 2015.

# 4. Next steps IASB

- In July 2012, the IASB received a summary of the recent Insurance Contracts Working Group (the Working Group) meeting.
- Discussion about adjustments to the **residual margin** and the **presentation of 'earned premium' in the statement of comprehensive income** and **transition**.
- Finalise decisions pertaining to participating contracts.
- The IASB will continue its joint discussions with the FASB on the Insurance Contracts project at their meeting in September and October 2012.

•Update vor der Sitzung, sobald die Agenda des IASB Board meeting im September veröffentlicht ist / siehe Agendapapier 09/01

# Agenda

1. Recap of the accounting model
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5. **Next steps DRSC**

# 5. Next steps DRSC

- **Sitzung der DRSC Arbeitsgruppe „Versicherungen“ am 26. Oktober 2012**
  - Auftrag?

Deutsches Rechnungslegungs Standards Committee e.V.
Accounting Standards Committee of Germany ®

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