# Public Discussion
# on
# ED/2013/7 *Insurance Contracts*

**Frankfurt am Main, September 30, 2013**

Franziska Schmerse

# AGENDA

1. Temporal overview and objective of the Standard
2. Significant changes in the Re-ED
3. Measurement on initial recognition of an insurance contract
4. Subsequent measurement of an insurance contract
5. Simplified approach for measuring the liability for the remaining coverage (PAA)
6. Measurement of participating contracts
7. Reinsurance contracts held
8. Presentation of insurance contract revenue
9. Presentation of interest expense
10. Effective date and transition

# 1. Temporal overview and objective of the Standard

Publication of the ED/2013/7 *Insurance Contracts*

June 20, 2013

End of comment period

October 25, 2013

Effective date approximately 3 years from the date of publication

???

Objective:

- provide a uniform basis for the accounting of insurance contracts
- improve the transparency of the effects of insurance contracts on an entity's financial position and financial performance
- provide useful information to users of financial statements about the nature, amount, timing and uncertainty of cash flows from insurance contracts

# 2. Significant changes in the Re-ED

**Measurement**
- Adjusting the contractual service margin (CSM) for changes that relate to future service
- Mirroring-approach for participating contracts

**Presentation**
- Insurance contract revenue as a volume size
- Recognition of changes in the discount rate in OCI

**Transition**
- Retrospective approach to transition

Issues on which the IASB invites comments

# 3. Measurement on initial recognition of an insurance contract

**General measurement model: Building blocks**

Insurance contract liability

**Contractual service margin**
- → CSM = unearned profit
- → recognition unless the portfolio of contracts is onerous
- → objective: no gain at inception

Fulfilment cash flows

**Risk adjustment**
- → no specification of the technique that is used
- → but: disclosure of the result of the chosen technique into a confidence level is required

**Time value of money**
- → discounting future cash flows with discount rates which are consistent with current market prices in a ‚top-down' approach or a ‚bottom-up' approach

**Future cash flows**
- → estimates of all cash inflows and outflows that relate directly to the fulfilment cash flows of the portfolio of contracts incorporating all available information

# 4. Subsequent Measurement of an Insurance Contract

Fulfilment cash flows at that date + Remaining amount of the contractual service margin = Carrying amount of an insurance contract at the end of the reporting period

| | |
|---|---|
| | CSM at the start of the reporting period |
| + | accretion of interest |
| | amount recognised for services that were provided |
| +/- | **favourable/unfavourable changes in the future cash flows which relate to future coverage / service** |

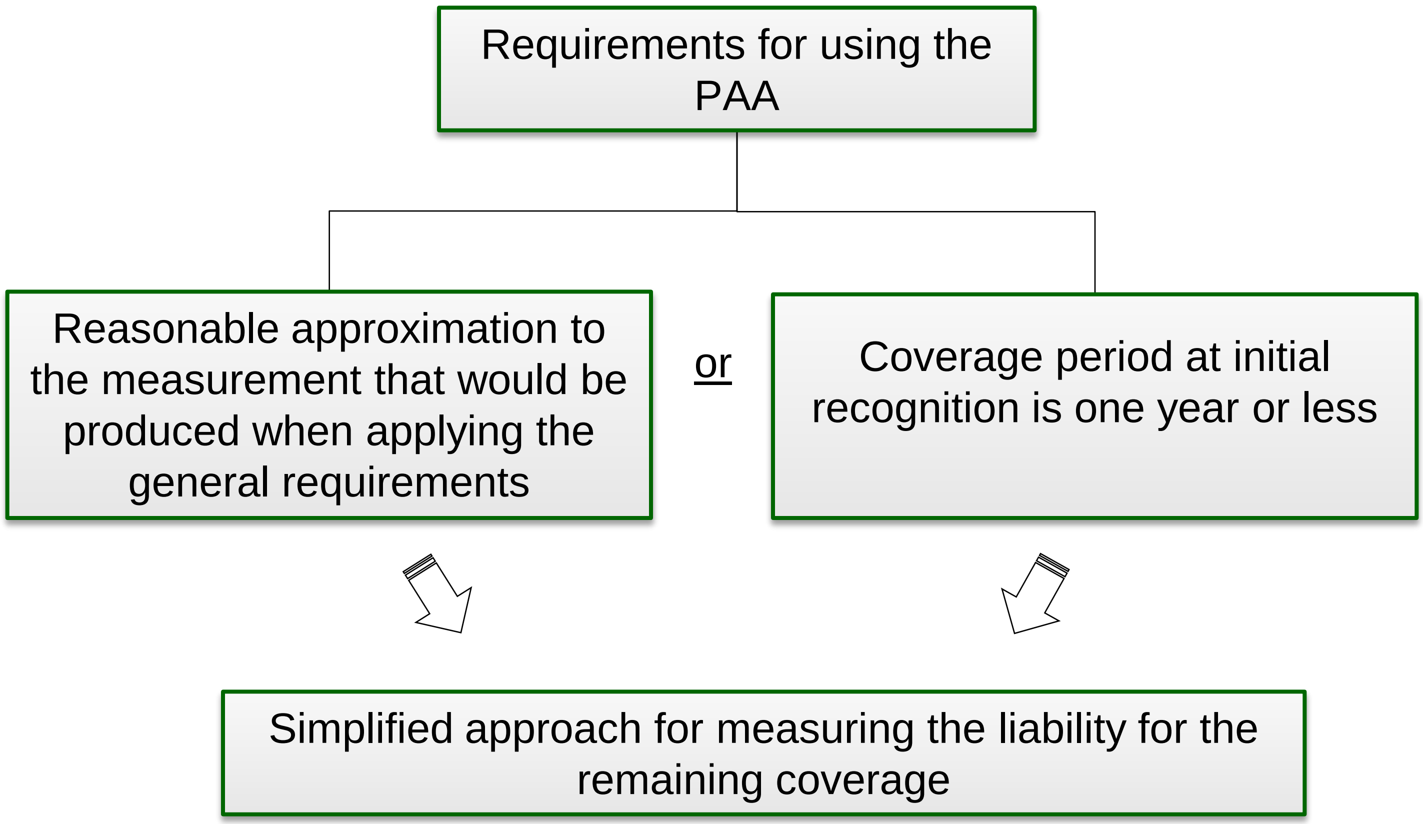
- recognition of the CSM over the coverage period in the systematic way that best reflects the transfer of services
- adjustments of the CSM upwards is unlimited
- adjustments of the CSM downwards to the extent that the CSM is sufficient to absorb unfavourable changes; the CSM shall not be negative

# 4. Subsequent Measurement of an Insurance Contract

Which changes lead to an adjustment of the CSM?

| | | |
|---|---|---|
| CSM is adjusted | Changes in future cash flows that relate to future coverage or other future services | CSM ↑ or ↓ |
| CSM is not adjusted | Experience adjustments | P+L |
| | Changes in the discount rate | OCI |
| | Changes in the risk adjustment | P+L |
| | Changes in the underlying item | P+L/OCI |

# 5. Simplified approach for measuring the liability for the remaining coverage (Premium Allocation Approach)



# 5. Simplified approach for measuring the liability for the remaining coverage (Premium Allocation Approach)

Measurement on initial recognition under the PAA

- carrying amount of the liability is based on the premium received

Subsequent measurement under the PAA

- no adjustment of future cash flows needed for contracts ≤ one year (unless the contract is onerous)
- recognition of the liability for the remaining coverage over the coverage period in the systematic way that best reflects the transfer of service
- no adjustment to reflect the time value of money according to para. 40

# QUESTION 1 – ADJUSTING THE CSM

Do you agree, that:

a. differences between the current and previous estimates of future cash flows related to future coverage and other future services are added to, or deducted from, the CSM, subject to the condition that the CSM should not become negative; and

b. differences between the current and previous estimates of future cash flows that do not relate to future coverage and other future services are recognised immediately in P+L?

Tentative view of the ASCG's IFRS-Committee

- general agreement with the proposal
- concern: no fully unlocking of the CSM

→ CSM should as well be adjusted for changes in the risk adjustment that relate to future coverage / other future services

- concerns relating the subsequent measurement of the CSM for participating contracts (Q2)
- accretion of the CSM should not be required for contracts where the entity could use the PAA but is using the general building blocks approach
- discount rate for the accretion of the CSM should be linked to the discount rate used to determine the interest expense in P+L

# 6. Measurement of Participating Contracts

## Background

- existence of contracts where the insurance contract liability is dependent on the result of underlying items (assets etc.)
- consideration of the asset dependence within the measurement and presentation of the insurance liability in order to avoid an accounting mismatch

## Re-ED

- proposal of a separate model for the measurement of those contracts
- avoidance of the mismatch by means of a consistent measurement and presentation of the insurance liability and the underlying items

## Requirements

1. contract requires the entity to hold specified underlying items
2. contract specifies a link between the payments to the policyholder and the returns on those underlying items

# 6. Measurement of Participating Contracts

| | CF vary **directly** | CF vary **indirectly** | CF do **not vary** |
|---|---|---|---|
| Measurement | **Mirroring**: reference to the carrying amount of the underlying items | ‘building block’ approach | |
| P+L | **Mirroring**: changes in the fulfilment cash flows are recognised on the same basis as the recognition of changes in the value of the underlying items | interest expense using a current rate | interest expense using a locked-in rate |
| OCI | | | changes in the discount rate |

Example: Bifurcation of the savings contributions (endowment life insurance)

| variable CF | option | fixed CF |
|---|---|---|

# 6. Measurement of Participating Contracts

## Example for the bifurcation of cash flows (B86)

- minimum payment to the policyholder = 1.000 CU
- plus 90 % of the increase in the fair value of the underlying assets (A)

A — 1.000 CU + [90% (Max.(A-1.000 CU);0 CU)] ✗

B — A + [(Max.(1.000 CU – A); 0 CU)] – [10% (Max. (A-1.000 CU); 0 CU)] ✗

C — [90% x A] + [90% (Max.(1.000 CU-A);0 CU)] + 100 CU ✓

| [90% x A] | [90% (Max.(1.000 CU-A);0 CU)] | 100 CU |
|---|---|---|
| varies **directly** | varies **indirectly**; option | does **not** vary; fixed |
| **Mirroring** | **Building Block,** interest expense using a current rate | **Building Block,** interest expense using a locked-in rate |

## QUESTION 2 – CONTRACTS THAT REQUIRE THE ENTITY TO HOLD UNDERLYING ITEMS AND SPECIFY A LINK TO RETURNS ON THOSE UNDERLYING ITEMS

Do you agree to the following measurement and presentation requirements?

a. vary directly → reference to the carrying amount of the underlying items
b. do not vary directly → general requirements of the Standard (building blocks)
c. recognising changes
    a. vary directly → same basis as the recognition of changes of the underlying items
    b. no not vary directly → P+L
    c. do not vary → P+L/OCI in accordance with the general requirements

<u>Tentative view of the ASCG's IFRS-Committee</u>

- no support of the IASB's model because:
    - limited scope leads to an inconsistent accounting for economically similar contracts
    - model is separate and not in line with the general measurement requirements (building blocks)
    - bifurcation of cash flows: hardly feasible, leads to a different measurement and presentation for a single contract, hard to understand for users
    - changes in the value of options and guarantees do not lead to an adjustment of the CSM ⇒ not consistent with the definition of the CSM
- support of the alternative approach for participating contracts

# EXCURSUS: ALTERNATIVE APPROACH FOR PARTICIPATING CONTRACTS

## Principle: Building block model

### Cash flows

- consideration of the dependence of the liability on asset returns etc.
- consideration of all contractual or discretional services of the asset returns when determining the liability
- cash flows have to be adjusted when the entity expects changes in the returns of assets
- value of options and guarantees is implemented within the cash flow projection

### Time value of money

- asset dependence is considered within the determination of the discount rate (para. 26(a))
- the discount rate for determining the interest expense in P+L has to be adjusted when the entity expects changes in returns to affect the amount of those cash flows (para. 60(h))
- duration of the liability = duration of underlying items
  ⇒ discount rate is based on asset returns
- duration of the liability > duration of underlying items
  ⇒ discount rate is based on the expected reinvestment returns

# EXCURSUS: ALTERNATIVE APPROACH FOR PARTICIPATING CONTRACTS

Principle: Building block model

**Risk adjustment**

- according to the general requirements (building block model)

**Contractual service margin**

- prospective determination of the CSM
- CSM has to be adjusted for all changes that affect the future profitability / future coverage / future services
- adjusting the CSM for changes in underlying items including reinvestment assumptions, when they relate to future coverage
- adjusting the CSM for changes in the value of options and guarantees
- release pattern of the margin is based on the changes of the present value of expected future profits

# EXCURSUS: ALTERNATIVE APPROACH FOR PARTICIPATING CONTRACTS

## Advantages of the alternative approach

- model is built on the general measurement requirements of the Re-ED (‘building blocks’)
- single measurement model for all kinds of insurance contracts; economically similar contracts are accounted in the same way
- significant reduction of complexity, because there is no need to split the liability
- definition of the CSM as the unearned profit is maintained for the participating business as well
- prospective determination of the CSM facilitates the approach to transition

# 7. Reinsurance contracts held

## Classification

1. Reinsurance contracts on an *aggregate loss basis*

   ⇒ Reinsurance contracts providing coverage for the aggregate losses of a portfolio of underlying contracts

2. Reinsurance contracts on an *individual loss basis*

   ⇒ Reinsurance contracts providing coverage for the loss of individual underlying insurance contracts

## Fulfilment CF

- assumptions have to be consistent with the underlying contract
- consideration of the risk of non-performance by the issuer
- risk adjustment has to represent the risk being transferred

## CSM

- based on the reinsurance contract
- net cost / net gain on purchasing reinsurance = CSM
- calibration of the CSM to the reinsurance premium
- release gains / losses over time

# 7. Reinsurance contracts held

Tentative view of the ASCG's IFRS-Committee

- **agreement** with the IASB's differentiation between reinsurance contracts as this adequately reflects the nature of reinsurance business
- the committee does **not agree** with the determination of the for reinsurance contracts on an individual loss basis
- the committee does **not agree** with recognising gains / losses from purchasing reinsurance over time

**Alternative approach for reinsurance contracts on an individual loss basis**

- consideration of the dependence of the reinsurance contract on the underlying contract when determining the CSM $\Rightarrow$ determination on the basis of the underlying contract
- CSM should reflect the reinsurer's share in the risk of the underlying business $\Rightarrow$ implies determination of the CSM based on the ratio of risk adjustments applied to the CSM of the underlying contract
- recognition of gains / losses immediately in profit or loss in order to avoid accounting arbitrage

# 8. PRESENTATION OF INSURANCE CONTRACT REVENUE

## Presentation of revenue and expenses in P+L / OCI

- insurance contract revenue excluding investment components
- incurred claims and other expenses relating to the insurance contract
- expense of purchasing reinsurance contracts held

**Revenue BBA**

Sum of:

- latest estimates of the expected claims and expenses relating to coverage for the current period
- change in the risk adjustment
- amount of the CSM recognised in P+L in the period
- allocation of the portion of the premium that relates to recovering directly attributable acquisition costs

Disclosure:

- disclose premiums written to enhance comparability of the new business

**Revenue PAA**

- amount of the expected premium receipts allocated in the period

# 8. Presentation of Insurance Contract Revenue

| ED 2010<br>Summarised margin | | ED 2013<br>Gross performance |
|---|---|---|
| + change in CSM | + change in risk | |
| change in risk | change in risk | insurance contract revenue |
| | +/- claims/expenses expected | |
| +/- experience adjustments | | |
| | - claims/expenses incurred | - claims/expenses incurred |
| **Operating result** | **Operating result** | **Operating result** |

*[see snapshop IASB]*

# QUESTION 3 – PRESENTATION OF INSURANCE CONTRACT REVENUE

Do you agree that financial statement would provide relevant information that faithfully represents the entity's financial performance if, for all insurance contracts, an entity presents, in P+L, insurance contract revenue and expenses, rather than information about the changes in the components of the insurance contracts?

<u>Tentative view of the ASCG's working group *Insurance*</u>

- no support for the definition of the insurance contract revenue
- the committee appreciates the consistency with the revenue recognition project and the enhanced comparability within the insurance industry and beyond
- concerns, because the determination is very complex, especially the required decomposition of investment components
- the informational content is questioned because it is an artificial size that has to be determined separately
- a more cash flow-related size is requested

# 9. Presentation of Interest Expense

**Interest expense in P+L**

Discount rate at the date that the contract was initially recognised

→ **locked-in discount rate**

**Recognition in OCI**

Difference between

- Carrying amount of using the discount rate that applied at the reporting date
- Carrying amount using the discount rate that applied at the date that the contract was initially recognised

- contracts with a **link to underlying items**:

  → entity shall update the discount rates when the entity expects any changes in those returns to affect the amount of those cash flows

# QUESTION 4 – INTEREST EXPENSE IN PROFIT OR LOSS

Do you agree to the following?

a. recognising the interest expense using the discount rate that applied at the date that the contract was initially recognised in P+L;
b. recognising the difference between the discount rates that applied at the date that the contract was initially recognised and the discount rates that applied at the reporting date in OCI;
c. CF that vary with underlying items: update those CF when changes affect those CF?

<u>Tentative view of the ASCG's IFRS-Committee</u>

- agreement with the proposal
  - provides relevant information by obtaining current balance sheets and profit and loss statements
  - reflects the long term nature of the insurance business
- FVTPL-option is necessary in order to avoid an accounting mismatch, because:
  - FV-OCI is not eligible for all assets
  - some contracts are managed on a FVTPL-basis ⇒ recognition in OCI is not appropriate for those contracts
- proposals regarding hedge accounting have to be clarified and developed further

# 10. Effective date and transition

**Effective date**

- approximately three years from the date of publication; early application is permitted

**Principle: Retrospective approach to transition**

- determination of the components of the building blocks based on the assumptions at the date of initial recognition
- estimate of the CSM ⇒ enables comparability between new and old business

**Simplified approach**

- when it would be impracticable to measure an insurance contract retrospectively
- simplified estimates of cash flows, discount rate, risk adjustment and CSM with the information that are available on the date of initial recognition

# QUESTION 5 – EFFECTIVE DATE AND TRANSITION

Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Tentative view of the ASCG's IFRS-Committee

- agreement with the retrospective approach to transition and the simplified approach
- enhanced comparability due to the retrospective approach
- simultaneously increases the complexity, especially because:
  - mirroring-approach with the bifurcation of cash flows
  - no consistent unlocking of the CSM

⇒ alternative approach for participating contracts simplifies the transition

- consistent effective date for IFRS 9 and IFRS 4 phase II
  - minimises the operationally complexity
  - enhances the comparability and the comprehensibility for users
  - if there is no possibility to align both Standards we would like to require a fully reclassification under IFRS 9 when the entity applies IFRS 4 phase II for the first time

# QUESTION 6 – THE LIKELY EFFECTS OF A STANDARD FOR INSURANCE CONTRACTS

Considering the proposed Standard as a whole, do you think that the costs of complying with the proposed requirements are justified by the benefits that the information will provide?
How are the costs and benefits affected by the proposals in Q1-5?
How do costs and benefits compare with any alternative approach that you propose and with the proposals in the 2010 ED?

Tentative view of the ASCG's IFRS-Committee

- implementation of the Standard is an significant investment
- some proposals increased the complexity of the implementation in comparison to the 2010 ED but this is appropriate in order to depict the insurance business adequately
- high costs may be justified only if the proposed model can be used for internal steering and management purposes ⇒ still changes needed to achieve that (e.g. participating contracts)
- disproportionate costs / complexity in some areas (e.g. confidence level, presentation of revenue, mirroring…)

# QUESTION 7 – CLARITY OF DRAFTING

Do you agree that the proposals are drafted clearly and reflect the decisions made by the IASB?

Tentative view of the ASCG's IFRS-Committee

- we welcome that the IASB created a principle-based Standard
- some examples are counterproductive, e.g. the example to the mirroring-approach
- in some parts the Standard is hard to understand; industry based language

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

Zimmerstr. 30
10969 Berlin

Tel. 030 20 64 12 0
Fax 030 20 64 12 15

www.drsc.de
info@drsc.de