The comment letters are in!
IFRS 4 Phase II

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Agenda

- Background
- Deloitte response on five key topics re-exposed
- The likely effects of the Standard

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Background

What have you been reading in the past four months?

- The IASB re-exposed in the revised exposure draft (revised ED) changes in five key areas without seeking further comments on other topics.

- These 5 areas were:
  - Adjusting the unearned profit from insurance contracts -'Unlocking of contractual service margin (CSM)'
  - Presentation of interest expense between profit or loss and the other comprehensive income ('OCI') - 'the OCI solution'
  - Accounting for contracts that specify a link to the returns on underlying items that the entity is required to hold – the 'Mirroring Approach' for participating contracts
  - Presentation of insurance contract revenue and expenses -'Earned premium approach'
  - Effective date and transition – Retrospective application with some practical expedients

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The CSM unlocking as proposed in the revised ED

Explicit unearned profit and its interaction with fulfilment cash flows

- Initial recognition – the CSM is calibrated to the fulfilment cash flows (including risk adjustment) and it represents the unearned profit of the insurance contract
- Subsequent measurement – CSM is released to earn profit over the coverage period and adjusted only for changes in the expected cash flows related to future coverage and other future services. All other changes to be recognised in profit or loss.
- The CSM cannot be negative

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Deloitte Comment Letter proposal on CSM

A number of material areas need to be improved to reflect portfolio economics

Welcome unlocking

- Better reflection of CSM's nature as an unearned profit
- Clarification that CSM cannot be negative

Propose to modify

- To extend CSM earning period beyond coverage
- To adjust CSM for prospective changes in risk adjustment (RA)
- To not restrict CSM unlocking for changes in future CFs (other than for changes in discount rate when 'OCI solution' is used)

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Deloitte CSM unlocking proposals in more detail

Provision of service does not stop at coverage

- Release CSM over combined coverage and claims handling period
- Establish CSM to be released post coverage in a PAA unexpired coverage liability

Unearned profit should reflect changes in risk of future cash flows and P+L should reflect expiry of risk in the period

- Unlock CSM for prospective changes in RA from changes in assumptions
- Release in the period change in RA of outstanding contracts keeping assumptions the same as at the beginning of the period

Unearned profit measure should reflect changes in all future cash flows (except for discount rate changes given the 'OCI solution')

- Unlock CSM for changes in estimates of future CFs depending on investment returns of underlying items is consistent with treatment of all other changes in future cash flows

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The OCI solution

Dealing with interest rate fluctuations and insurers' performance

Objective of the OCI solution

- Provide information that faithfully represents the financial performance by segregating the effects of underwriting performance from the effects of changes in discount rates
- This approach recognises that an insurance liability is not liquid, therefore the impact of interest rate fluctuations should not be reflected in profit or loss as these will unwind
- IFRS 9 will introduce a new category 'fair value through OCI' for bonds

Proposed accounting treatment

- Changes in insurance liability arising from changes in discount rate presented in OCI. Interest expense recognised in profit or loss determined using the discount rate that applied at the date that the insurance liability was initially recognised
- For participating contracts the "mirroring approach" has precedence over OCI solution
- Derivatives not allowed to be accounted for under OCI solution in IFRS 9 or revised ED

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The OCI solution

Some issues and practical considerations

Issues

- Fair Value through OCI will be available for debt instruments, but accounting mismatches may not be entirely eliminated, for example:
  - Assets at Amortised Cost or Fair Value through Profit or Loss
  - Where a derivative is used to manage a gap between the duration of the insurance liability and the backing assets, changes in the fair value of the derivative are recognised in profit or loss
- Impacts on post claim liabilities where Premium Allocation Approach (PAA) is applied

Practical considerations

- Will need to maintain two sets of balance sheet data: one at current interest rates and one at the original locked-in rate. It will be necessary to determine the specific assets that back the insurance liability to prevent an accounting mismatch
- Tracking insurance contract liabilities and backing assets, and changes in interest rates, is potentially demanding

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Deloitte Comment Letter on the OCI solution

Support development in conjunction with IFRS 9

- Reduction in accounting mismatches

Propose to modify

- Permit designation of insurance contracts – no mandatory OCI
- Failing this, allow presenting in profit or loss changes in insurance contracts accumulated OCI reserve to the extent that they represent gains/losses attributable to the hedged risk
- Unconstrained ability to adopt FV option on assets

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Deloitte OCI solution proposals in more detail

Presentation of part of the interest expense through OCI

- Does not fully capture the nuances of asset-liability management
- Results will leave a substantial number of accounting mismatches

Interaction with financial instruments

- The OCI solution may not reduce significant accounting mismatches, even when the cash flows from assets and liabilities are economically matched, due to the mixed financial asset measurement model combined with a mandatory OCI solution on insurance liabilities

A non-mandatory OCI solution

- OCI solution depends to a significant extent on the ALM strategy selected
- The designation of which insurance contracts will use the OCI solution and which will reflect all changes in discount rate through profit or loss should be introduced
- Unconstrained ability to adopt a fair value option is critical to ensure symmetry of application to financial instruments and insurance contracts

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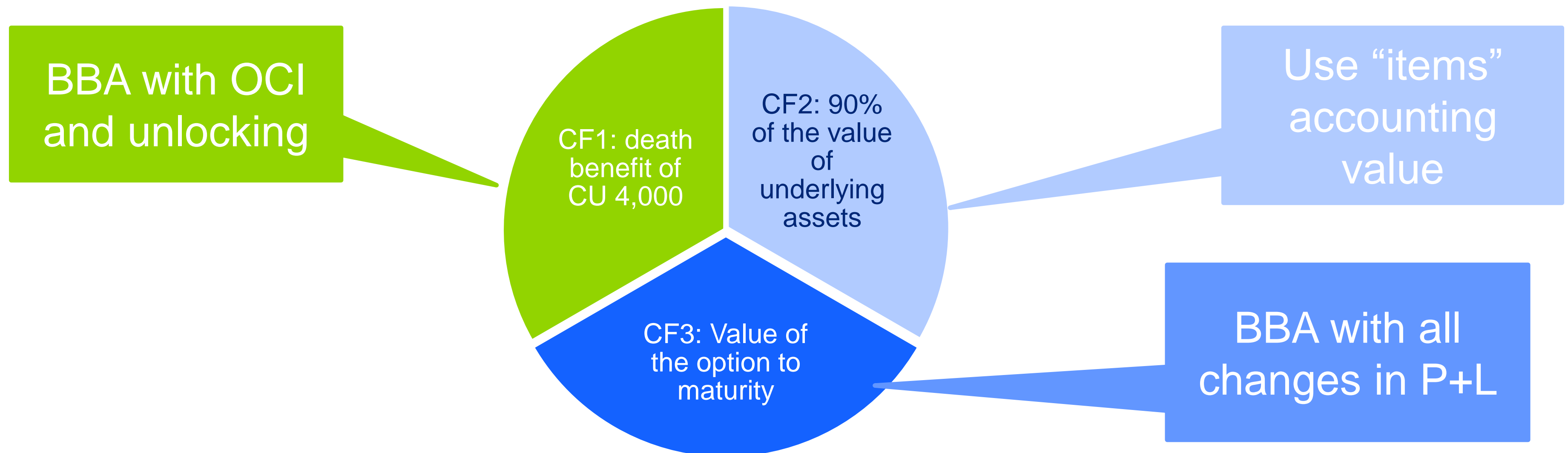
Participating contracts 'mirroring approach'

- Need to 'decompose' the different sets of cash flows in a contract to identify those cash flows that vary directly with the underlying assets

Illustrative example

- 5-year contract with a single premium of CU2,000 received at inception.
- Surrender and maturity values are 90 per cent of the value of a specified pool of assets held by the company where his premium was invested
- Death before the end of 5 years triggers a fixed death benefit of CU4,000
- Maturity value is guaranteed to be at least CU2,000



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Deloitte comment on approach to 'mirroring approach'

Agree that economically matched asset-liability cash flows should be faithfully represented

Propose to modify

- Abandon the mirroring approach decomposition
- Replace it with a BBA valuation modified in two areas:
- Discount rate should mirror the "book yield" of the underlying items; and
- The CSM should be unlocked with inclusion of expected returns from underlying items not captured in the liability (insurer's share)

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Deloitte ‘mirroring approach’ proposals in more detail

Separate model is complex and unrepresentative of a contract as a bundle of different cash flows

- Scope is not well defined (paragraph 33)
- Analysis of CFs into 3 types is complex and artificial resulting in different measurement and presentation for each
- Results are inconsistent with economic design and pricing of embedded derivative features
- ‘Mirroring’ produces misleading results if underlying items are not at FV
- No guidance how to apply ‘mirroring’ if underlying is a pool of insurance contracts or results of entity itself

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Deloitte ‘mirroring approach’ proposals in more detail (cont.)

Propose to account for all participating contracts using the same accounting model as all other insurance contracts with two key modifications

Amendment to discount rate

- Accrete interest on directly linked cash flows using the yield generated by those underlying items limited to their expected duration.
- For cash flows beyond duration of underlying items estimate discount rate using the general provisions of the revised ED.
- The difference between the rate estimated above and the current rate in the B/S would be recognised in OCI if the entity elected to use ‘OCI solution’

Unlocking of CSM for the returns on underlying items attributable to the insurer

- Propose to adjust the CSM for the returns on underlying items attributable to equity holders until the distribution to policyholders is made
- This would reflect the fact that insurer provides a service to current and future policyholder (B66(k)) by allowing them participation in the underlying items
- The insurer’s obligation to policyholders is not fulfilled until the distribution is made

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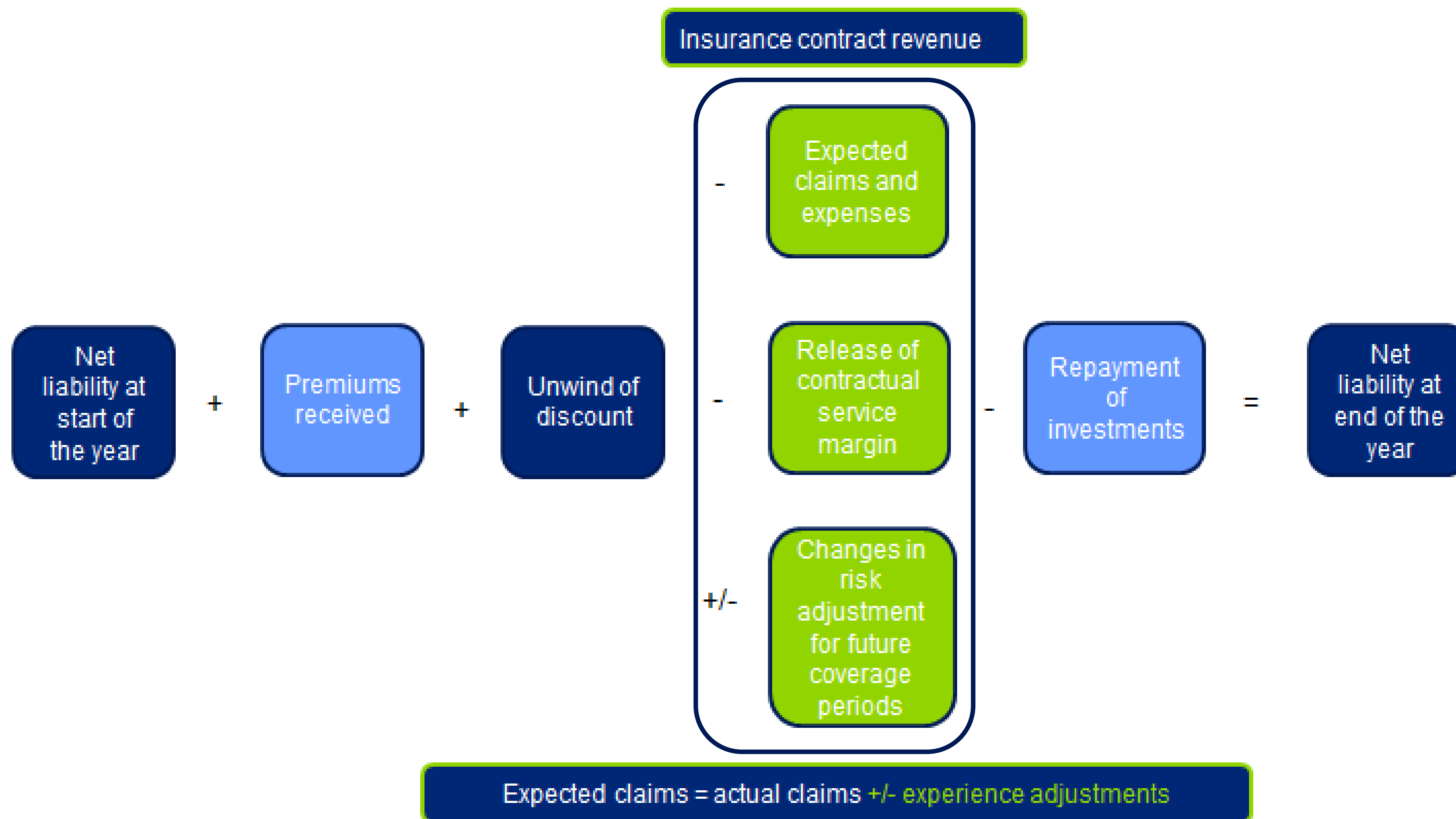
Presentation of revenue and expenses

The reengineering of the balance sheet movements to produce a new revenue



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Deloitte Comment Letter on presentation of revenue and expenses

Propose to modify

- New revenue metric is not the most faithful representation of long duration contracts
- New insurance revenue does not appear to be the volume information requested by investors
- Recommend the presentation of the summarised margin as presented in the 2010 ED

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Deloitte presentation of revenue and expenses proposals in more detail

Concerns about the proposals in the 2013 ED

- The proposed new revenue metric would not be the most faithful representation of the contribution that long duration contracts make to the financial performance as it is in conflict with the portfolio of contacts as a unit of account
- The desire to develop a common presentation requirement should be measured against the different characteristics of different types of insurance contracts portfolios
- We believe that the Board should accept the co-existence of two different presentation requirements for short and long coverage duration contracts
- The new revenue does not appear to provide the volume information requested by investors

Summarised margin approach

- Present the the summarised margin in the statement of comprehensive income appears to be preferable with PAA presentation as a policy option
- We support disclosing the effect of the insurance contracts on initial recognition on the amounts that are recognised in the statement of financial position. This would show separately the effect on the expected present value of future cash inflows, outflows, risk adjustment and CSM.

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Approach to transition

Retrospective application with some practical expedients

Full retrospective application with a set of pragmatic measures

- Measure the insurance contract at the sum of the fulfilment cash flows in accordance with the standard and an estimate of the remaining CSM
- Estimate the liability, excluding any losses on the date of initial recognition and any changes in the estimates between the date of initial recognition and the beginning of the earliest period presented that were immediately recognised in profit or loss
- Determine, for the purpose of measuring interest expense to be recognised in profit or loss, the discount rates that applied when the contracts were initially recognised
- Estimate the discount rates that applied at the date of initial recognition using an observable yield curve that approximates to that estimated in accordance with the Standard. If such a curve does not exist, estimate the discount rates by determining an average spread between an observable curve and the curve calculated in accordance with the Standard, and apply that spread to that observable curve
- Do not need to undertake exhaustive efforts to obtain objective information, but shall take into account all objective information that is reasonable available

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Approach to transition

Re-designation of financial assets – the interaction with IFRS 9

Re-designation of financial assets

- At the beginning of the earliest period it is permitted but not required to re-designate a financial asset at FVTPL if this would significantly reduce an accounting mismatch.
- If IFRS 9 has previously been applied, designate an investment in an equity instrument at FVOCI or revoke a previous election to use FVOCI
- Required to revoke previous designations at FVTPL if the initial application of the Standard eliminates the accounting mismatch

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Deloitte comment on approach to transition

Agree that exhaustive efforts not required

- Full retrospective approach is the most appropriate and accurate method
- If this is impracticable, need not undertake exhaustive efforts to obtain objective information
- Insurance contracts based on fulfilment cash flows
- A period of 3 years is sufficient to allow implementation

Propose to modify

- Consider FASB proposal to measure CSM by aggregating contracts at the portfolio level
- Encourage effective dates of insurance contracts Standard and IFRS 9 to be aligned
- Failing this, an option to reclassify financial assets
- An unconstrained ability for an irrevocable option to adopt fair value on assets

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Deloitte approach to transition proposals in more detail

Alignment of the measurement of financial assets and insurance liabilities

- We encourage the alignment of the effective date of the new IFRS on insurance contracts and IFRS 9 (as amended) to be aligned, with early application permitted
- If not, include option to reclassify financial assets to alleviate concerns about classifying investments without knowing accounting requirements for insurance liabilities
- An unconstrained ability to adopt a fair value option is critical to address accounting mismatches across different asset-liability management strategies
- Option designated at initial recognition and be irrevocable, therefore little risk for this to be subject to abuse, and the reason for choosing the option should be disclosed

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The likely effects of a Standard for insurance contracts

Balancing the costs with the benefits

Global IFRS Insurance Survey 2013

- The Economist Intelligence Unit surveyed 300 insurers to investigate their views on the proposed IFRS for insurance contracts

The waiting is over

- The IASB has given a clear indication that the mandatory effective dates for IFRS 4 and IFRS 9 are set within a narrow range
- This has removed years of uncertainty for the industry and has given the green light to insurers that they can begin their preparations
- 59% have started IFRS projects, and 85% believe they will have completed the work within the expected three year timeline proposed by the IASB

Cost is the key

- Since the adoption of the new standards rewrites the rules for financial reporting for the industry, the transition will be complex
- Worries over the cost of implementation dislodge previous concerns over uncertainty
- Insurers predict the average budget for the changes required as a result of implementing the Standards will be between \$25m and \$50m

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Deloitte Insights into IFRS Insurance (i2ii)

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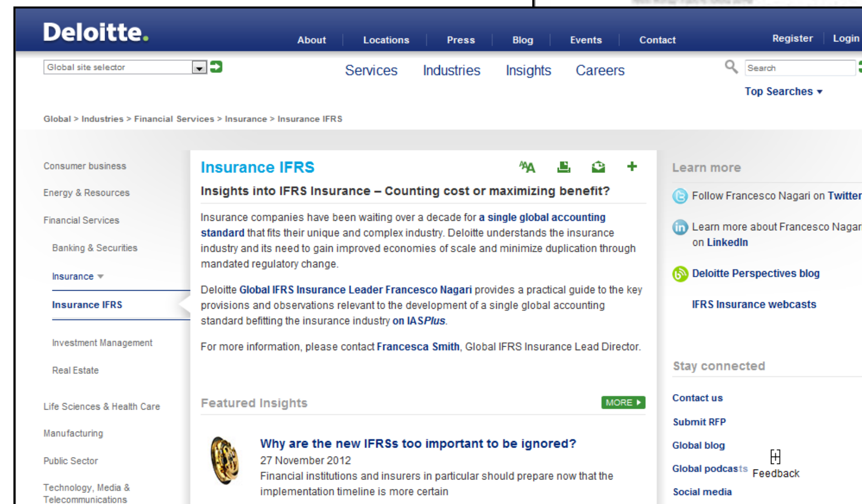

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