The last (and longest) mile

IASB starts its re-deliberations on participating contracts

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Agenda

- Highlights of decisions from IASB meeting this month
- IASB staff recommendations and Board discussions
- Next steps and update on timetable

Highlights

- Meeting held on 17 June 2014
- Accounting for participating contracts move one notch up the IASB engagement from educational in May to this month session which delivered directions to IASB staff on two key issues:
  - Unlocking CSM with insurer's share of underlying items should be explored on the basis it represents implicit revenue
  - Book yield for time value of money presentation should be restricted to situations where underlying items are held and their return is significant for the customer
- Three final non-targeted areas also approved:
  - Guidance on discount rates for long durations;
  - Level of required CSM aggregation/granularity
  - Revision of reinsurance assets "no gain" rule

Contracts with Participating Features
The insurer’s share of underlying items

Can the insurer’s share be considered to be an asset management fee?

Issue

- The 2013 ED mirroring approach has been rejected by several commentators
- A number of parties proposed as an alternative a building blocks approach modified such that the unlocking of the CSM for participating contracts includes the insurer’s share of the returns on underlying items (‘the insurer’s share’).
- The insurer’s share can be viewed as either an implicit management fee or the insurer’s economic interest in underlying items.

Staff analysis

- Adjusting the CSM for changes in estimates of the insurer’s share if it represents its economic interest would go beyond the proposals in the 2013 ED because the amounts do not relate to future service
- This would result in changes in estimates of the insurer’s share to be recognised immediately in profit or loss.

Contracts with Participating Features
The insurer's share of underlying items

Can the insurer's share be considered to be an asset management fee?

Staff recommendation

- If the IASB were to require an entity to adjust the CSM for the insurer's share on the grounds that this represents an implicit management fee, this should be considered to exist only when:
  1. the returns to be **passed** to the policyholder arise **from the underlying items the entity holds** (regardless of whether the entity is required to hold those items or whether the entity has discretion over the payments to policyholders);
  2. there is a **minimum fixed or determinable amount** that the entity must **retain**; and
  3. the policyholder will receive a **substantial share** of the total return on underlying items

Contracts with Participating Features
The insurer's share of underlying items

Can the insurer's share be considered to be an asset management fee?

Discussion

- Methodology concern was raised given adaptations were discussed before addressing the conceptual issues
- Complexity of the modified unlocking was raised as a concern
- The Staff stated that guidance would be provided on what constituted a "substantial share" of the total return on underlying items
- Concerns that if all adjustments accounted for in the CSM this would become a smoothing mechanism, and the net result would not be the main performance indicator
- Consistency with explicit management fee contracts is necessary

IASB directional vote

- 11 members agreed and 4 disagreed with the first two recommendations and 12 members agreed and 3 disagreed with the third recommendation

Contracts with Participating Features
The insurer's share of underlying items

What amounts should adjust the CSM?

Issue

- There are differing views on the amount of the adjustment to the CSM if the IASB were to agree in principle that the CSM should be adjusted by changes in estimates of the insurer's share.

Staff comments and IASB discussion

- Staff agreed to focus on adjusting the CSM for changes in estimates of the insurer's share:
    - measured consistently with the measurement of the fulfilment cash flows; and
    - determined on a basis that reflects the effect of the equivalent changes in estimates of the underlying items in profit or loss.

Contracts with Participating Features
The book yield approach

The merit of a book yield approach

Staff analysis

- This approach only related to presentation, not measurement when changes in the discount rate are presented in OCI.
- The main difference between the book yield approach and the mirroring exception arises when the underlying assets are measured at cost, where this approach measures the liability consistent with the building blocks approach.

Staff recommendation

- The book yield approach should be applied only when
  1. the returns to policyholder arise from the underlying items that the entity holds (regardless of whether the entity is required to hold those items or whether the entity has discretion over the payments to policyholders), and
  2. the policyholder will receive a substantial share of the total return on underlying items

Contracts with Participating Features
The book yield approach

The merit of a book yield approach

Discussion

- Similar to the OCI solution for non-participating contracts.
- Added complexity, with one discount rate to determine the balance sheet value and another for presentation purposes, and the use of the book yield approach where the criteria were met and the OCI approach for all other cases.
- The Staff confirmed that the book yield would be determined at each reporting date, with any difference between the interest charged in profit or loss and the impact of the discount rate in measuring the contract liability included in OCI.
- Disagreement that the book yield approach would not lead to significant differences to the other alternatives for determining the unwind of the discount rate in profit or loss and amounts in OCI.

IASB directional vote

- 12 members agreed and 3 disagreed

Non-targeted Issues

Determining discount rates when there is a lack of observable data

Staff analysis

- Both the measurement approach in the ED and the fair value approach in IFRS 13 place the same reliance on observable market information when applying valuation techniques to liabilities not held by other parties as assets.
- Observable market prices in active markets would not generally be available for insurance contracts
- Clarification sought on the approaches to extend the discount rate yield curve beyond the period for which there are observable interest rates in active markets

Non-targeted Issues

Determining discount rates when there is a lack of observable data

Staff recommendation

The IASB should:

- Confirm the market consistency principle for discount rates based on the cash flows characteristics of the insurance contract; and
- Provide additional application guidance that, in determining those discount rates, an entity should use judgement to:
  - ensure that appropriate adjustments are made to observable interest rates to reflect the characteristics of the insurance contract cash flows; and
  - develop any unobservable inputs using the best information available in the circumstances while remaining consistent with the objective of reflecting how market participants assess those inputs and without contradicting observable market data

Non-targeted issues

Determining discount rates when there is a lack of observable data

Discussion

- IASB members confirmed their support for the refinements included in the Staff recommendations
- The need to explain the rationale for making adjustments to market observable data should trigger disclosure requirements
- Equally important is the disclosure of the extrapolation beyond the horizon of observable interest rates is a critical judgment
- Concurred that the principles in IFRS 13 would still apply to the discount rate selection even if insurance contracts are not fair valued

IASB vote

- IASB agreed unanimously with the Staff recommendation

Non-targeted Issues

Asymmetrical treatment of gains from reinsurance contracts

Issue

- The 2013 ED ruled that no gain should be recognised on purchase of a reinsurance contract. Reinsured onerous portfolio scenarios warrant a reassessment of the merits of this rule

Staff analysis

- Different considerations apply after initial recognition
- Changes in estimates of cash outflows of reinsured insurance contracts that have corresponding changes in cash inflows from a reinsurance contract held should have no effect in profit or loss for the period
- In addition, when a reinsured portfolio becomes onerous changes in estimates of cash flows from the reinsurance asset should be recognised in profit or loss to reflect the protection received from the reinsurance contract held

Non-targeted Issues

Asymmetrical treatment of gains from reinsurance contracts

Staff recommendation

- Cedants should recognise in profit or loss any changes in estimates of cash flows of reinsurance contracts held whenever changes in the cash flows of reinsured insurance contracts are recognised immediately in profit or loss.

Discussion

- The Staff confirmed that they believe cedants can identify changes in reinsurance contract cash flows
- The trigger for a “reinsurance gain” is effectively an “onerous portfolio loss”

IASB vote

- IASB agreed unanimously with the Staff recommendations

Non-targeted Issues

Level of aggregation

Staff recommendation

The IASB should:

1. Clarify that the objective of the new IFRS is to provide principles for the measurement of an individual insurance contract, but an entity could aggregate insurance contracts provided that it does so in a way that meets that objective.
2. Amend the definition of a **portfolio** to *"insurance contracts that provide coverage for similar risks and are managed together as a single pool"* and delete the requirement that contracts *"are priced similarly relative to the risk taken on"*
3. Specify that:
   a) In determining the CSM for loss at initial recognition an entity should not combine onerous contracts with profit-making contracts
   b) In determining the CSM at subsequent measurement, an entity could combine contracts that have similar release patterns, absolute amounts of CSM at initial recognition, and similar inception dates and coverage periods

Non-targeted issues

Level of aggregation

Discussion

- The Staff explained that the criterion to have similar absolute amounts of CSM at initial recognition was to avoid having contracts with large and small CSMs being included the same portfolio
- If the contracts with small CSMs became onerous, a loss may not be recognised because the large CSM balances would have the capacity to absorb such losses.
- The release of the CSM as a result of lapses would require lapse assumptions to be made
- There was no support for the third recommendation by IASB members, therefore the Staff proposed that examples be provided that explained this principle instead of introducing a requirement

IASB vote

- Recommendations 1 and 2: 14 members agreed, and one disagreed. Recommendation 3 (as amended): 15 members agreed.

Non-targeted Issues

Level of aggregation – accounting policy choice for the OCI solution

Staff recommendation

- Clarify that an entity should select and apply its accounting policies consistently for similar contracts, taking into consideration the portfolio in which the contract is included and the related assets that the entity holds

Discussion

- Concerns were raised that this may limit comparability given that it is not always possible to identify assets backing insurance liabilities.
- Recommendation was changed to *".. an entity should select and apply its accounting policies consistently for similar contracts, taking into consideration the portfolio in which the contract is included* ***<u>and the way the assets are accounted for</u>****".*

IASB vote

- 10 members agreed, and 5 disagreed

The next steps and update on timetable

- The IASB plans to continue its discussions on the adaptations to its tentative decisions that would be needed for contracts with participating features over July and September meetings
- The remaining issues to be discussed in future IASB meetings on contracts that do not have participating features include:
  - The discount rate to be used to determine the present value of cash flows that adjust the CSM and used to accrete interest on the CSM; and
  - Follow up issues relating to OCI and the premium allocation approach.
- The final targeted topic that will be discussed at a future IASB meeting is the transitional requirements for the first time adoption including the effective date of the new IFRS on insurance contracts.
- The IASB expects redeliberations to be completed in 2014 and the publication of a final standard in 2015

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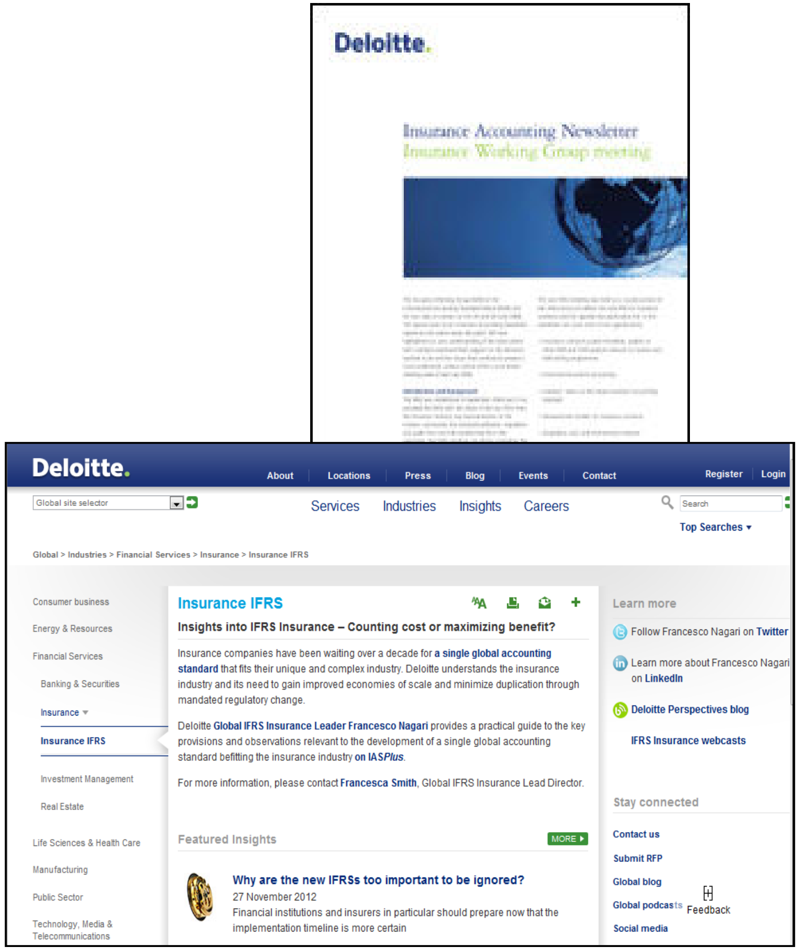

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