Further progress towards finalising IFRS 4 Phase II

Transition for contracts with no participating features

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Agenda

- Highlights of discussions about transition for non-participating contracts
- Detailed analysis of the staff recommendations and IASB discussion
- Taking stock on participating contracts, next steps and update on timetable

Highlights of discussions about transition for contracts with no participating features

- The IASB reaffirmed the conclusion in the 2013 ED that the proposed Standard should be applied retrospectively in accordance with IAS 8 unless impracticable

- If full retrospective application is impracticable the IASB reconfirmed that a simplified approach should be applied, but applying a modified approach to that proposed in the 2013 ED

- If the simplified approach is impracticable, the IASB decided that the CSM at the beginning of the earliest period presented should be the difference between the fair value of the insurance contract and the fulfilment cash flows measured at that date

- Additional disclosures when contracts have been measured in accordance with the simplified approach or the fair value approach.

Transition for contracts with no participating features

Initial application

Issues discussed at the meeting on 23 October 2014

- Whether an entity should, unless impracticable, apply the proposed Standard retrospectively.
- Whether the simplified approach proposed in the 2013 ED should be modified.
- Whether an alternative approach needs to be specified when it is impracticable to apply the simplified approach.

Transition for contracts with no participating features

Retrospective application

Staff analysis

- Widespread support, therefore little need to reconsider the proposal that insurers should apply the proposed Standard retrospectively, unless this is impracticable
- Concerns about operational complexity, lack of data, and subjective estimates
- At transition some insurers will recognise accumulated losses in OCI because interest rates have fallen since the date of initial recognition of the contracts. Such losses would be offset in the future by the release of the OCI reserve as time goes by
- In some other cases the CSM would be greater at the beginning of the earliest period presented than was originally expected because of favourable changes in mortality and expense assumptions
- This outcome accurately depicts the situation in which *investing losses* caused by interest rates being lower than originally expected are recognised in the period in which they arose, and *underwriting profits* that are greater than originally expected are recognised in profit or loss in future periods

Transition for contracts with no participating features

Retrospective application

Staff analysis (continued)

- Recognition of gains/losses from the effect of the discount rate on the insurance contracts would be consistent with gains/losses for financial instruments, and underwriting gains/losses would be consistent with the accounting for service contracts.

Staff recommendation

- At the beginning of the earliest period presented, an entity should apply the Standard retrospectively in accordance with IAS8 *Accounting Policies, Changes in Accounting Estimates and Errors*, unless impracticable

Transition for contracts with no participating features

Retrospective application

Staff comments and IASB discussion

- The salient points from the discussion were:
  - Widespread IASB support for estimating the CSM at the beginning of the earliest period presented
  - Concerns about operational complexity, lack of data, subjectivity and the extent to which such estimates are auditable
  - Individual insurers could apply full retrospective application for some products and business lines, but not for others where this is impracticable
  - Some insurers may recognise accumulated losses in equity because interest rates have materially fallen since the contracts were initially recognised
  - Negative equity could result when interest rates had materially fallen since contracts were initially recognised
  - Whether full retrospective application should be required because of the complexity, subjectivity and cost

Transition for contracts with no participating features

Retrospective application

Staff comments and IASB discussion (continued)

- Full retrospective application would not be able to accommodate the significant diversity of insurance regulations as they evolved over time.
- There were no long-term government bonds in several Asian markets, at the date that many contracts were initially recognised
- These last two points could create some material unintended consequences (e.g. negative equity) that could confuse investors
- It is better to achieve comparability on transition rather than implement the proposals over the remaining lives of the contracts
- The interpretation of ‘impracticable’ is exactly as defined in IAS 8. There will be no dilution of its rigorous application in the proposed Standard

IASB vote

➢ 9 IASB members were in favour of the Staff recommendation and 5 against.

Transition for contracts with no participating features

Simplified approach

Staff analysis

- Widespread support for the simplified approach
- Less costly than retrospective application
- Concerns about the lack of information required under the simplified approach
- Does not provide results that are fully comparable to retrospective application, but provides a closer approximation than a measure with a different objective
- Issues associate with the risk adjustment under the 2013 proposals
  - Would be understated at date of initial recognition if it is estimated as being equal to the risk adjustment at the beginning of the earliest period presented
  - This would cause an overstatement of the CSM (and hence an overstatement of the insurance contract liability and understatement of retained earnings)
  - Could be avoided by adjusting the risk adjustment by the expected release of the risk.

Transition for contracts with no participating features

Simplified approach

Staff recommendation

- If retrospective application is impracticable, an entity should use the simplified approach proposed in the 2013 ED, but modified as follows:
  - Instead of estimating the risk adjustment at the date of initial recognition as the risk adjustment at the beginning of the earliest period presented, this should be estimated by adjusting the risk adjustment at the beginning of the earliest period presented by the expected release of risk associated with prior periods
  - The "past" expected release of risk should be determined by reference to similar insurance contracts that the insurer issues at the beginning of the earliest period presented.

Staff comments and IASB discussion

- There was very little discussion about the above recommendation.

IASB vote

- There was unanimous agreement with the staff recommendation

Transition for contracts with no participating features

Fair value approach when simplified approach is impracticable

Staff analysis

- Fair value approach would apply when it is impracticable to apply the simplified approach
- It may be impracticable to use the simplified approach to estimate the CSM because of the lack of cash flow information
- In such circumstances a fair value measure would have these disadvantages:
  - reduced comparability; and
  - potential risk of overstatement of future revenue
- Staff concluded that it is always possible to estimate the discount rate as prescribed under the simplified approach.

Transition for contracts with no participating features

Fair value approach

Staff recommendation

- If the simplified approach is impracticable, an entity should apply a ‘fair value approach’ in which the insurer would:
  - determine the CSM at the beginning of the earliest period presented as the difference between the fair value of the insurance contract and the fulfilment cash flows measured at that date; and
  - determine the discount rate used for measuring interest expense in profit or loss and, where elected as an accounting policy, the related amount of OCI accumulated in equity, by estimating the discount rate at the date of initial recognition of the insurance contract using the method in the simplified approach proposed in the 2013 ED.

Transition for contracts with no participating features

Fair value approach

Staff comments and IASB discussion

- The salient points from the discussion were:
  - The Staff noted that the CSM would not be based on the premium that had been charged for the contract
  - Discount rates would not be known in those countries where only short-dated government bonds were available many years ago
  - The Staff stated that in such circumstances the yield curve would be extrapolated
  - Allowing three different approaches to transition within the same insurer would hinder comparability
  - Insurers may try to justify using extensively the fair value approach as this may be attractive in respect of the recognition of future profits and its implementation costs being lower than the full restatement and the simplified approach

Transition for contracts with no participating features

Disclosures

Staff recommendation

- For each period presented for which there are contracts measured in accordance with the simplified approach or the fair value approach, the information proposed in the 2013 ED should be separately disclosed for:
  - contracts measured using the simplified approach; and
  - contracts measured using the fair value approach

Staff comments and IASB discussion

- There was very little discussion about the above recommendation.

IASB vote on both recommendations

- 11 IASB members were in favour of the Staff recommendations in respect of the fair value approach and disclosures and 3 against these recommendations.

Profit recognition from participating contracts

Status quo of the IASB debate

- IASB acknowledged that the 2013 ED proposal to introduce a “mirroring approach” has been widely rejected by constituents
- Several commentators directed the IASB towards using the BBA with adaptations to reflect the nature of the participation feature included in these contracts: policyholders’ cash flows will incorporate a portion of returns generated from underlying items that the insurer holds
- The IASB accepts that this feature may be present in insurance contracts and financial instruments – the current scope will include some financial instruments with participation features and all insurance contracts

Profit recognition from participating contracts

Status quo of the IASB debate (cont.)

- The adaptations being considered are primarily around two areas
  - The “unlocking” of the CSM could take into account the changes in the insurer’s future share of return generated by the underlying items. The profit recognition basis for this adapted CSM should be defined
  - The accounting policy option to present the time value of money separately between profit or loss and OCI would use an asset dependent yield based on the projected crediting rates rather than the market consistent discount rate curve set at initial recognition
- In the event that the IASB accepts these adaptations it would become critical for them to consider the scope of application for these adaptations

Profit recognition from participating contracts

Status quo of the IASB debate (cont.)

- European CFO Forum has proposed a model for participating contracts that has been welcomed by the European Financial Reporting Advisory Group (EFRAG)
- This is a conceptual model that is applicable to all participating contracts. These are defined as those contracts that offer a variable return linked to a specified pool of assets irrespective of whether or not the actual assets are held by the insurer
- The scope is broad and would include European-style, Asian-style and American-style insurance contracts
- The scope will also capture a portion of contracts where there is no insurance risk transfer if the variable return includes a discretionary element derived from underlying items held by the insurer (investment contracts with discretionary participation)

Profit recognition from participating contracts

Status quo of the IASB debate (cont.)

The key features are

- No bifurcation of cash flows with a single discount rate curve for all cash flows (asset-dependent or not) for balance sheet measurement
- Book yield rate for the "presentation" of the time value of money in P&L with the difference to OCI
- Definition of the CSM of the insurer's share of future profits from the underlying items with full unlocking of all variables (including options and guarantees)
- Profit recognition based on the delivery of the service to the policyholder

The next steps

Meeting with CFO Forum, remaining issues and publication of the final Standard

- After the presentation from the European CFO Forum on 14 November the IASB may declare complete its preparatory activity on this topic which started in May
- The IASB may move in decision making sessions thereafter for participating contracts. They will also reassess the decisions reached on non-participating contracts and set the effective date of the proposed Standard
- Re-deliberations are now likely to be completed in early 2015, with the publication of a final Standard later that year.

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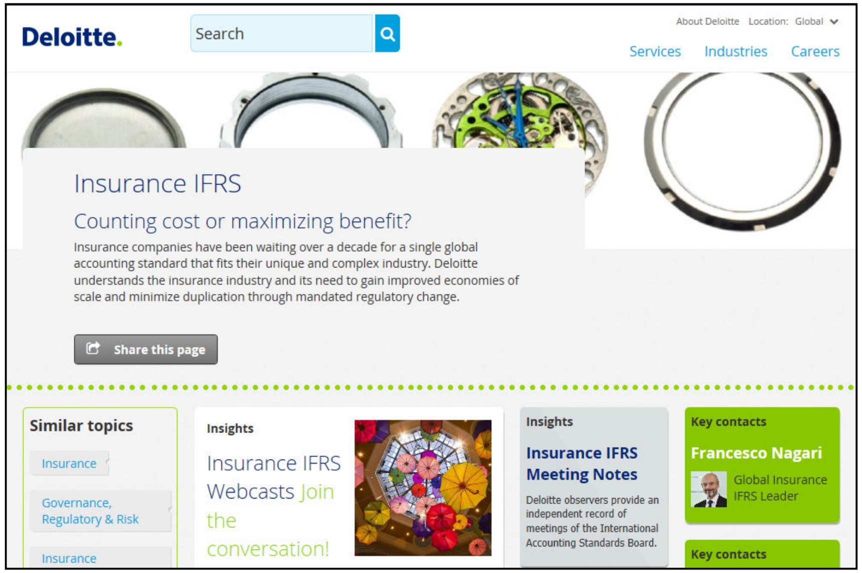

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