Deloitte.

Notes from the IASB meeting held on 17-19 June 2014

www.iasplus.com/en/meeting-notes/iasb/2014/june/insurance

Insurance contracts

Determining discount rates when there is lack of observable data

The issue here is whether the IASB should provide additional application guidance on how an entity should apply the principle in the 2013 ED that the discount rates used to adjust the cash flows in an insurance contract for the time value of money should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract when there is no or limited observable data.

The Staff analysis noted that both the measurement approach in the 2013 ED and the fair value measurement approach prescribed in IFRS 13 *Fair Value Measurement* place the same reliance on observable market information when applying valuation techniques to liabilities not held by other parties as assets. However, observable market prices in active markets would not generally be available for insurance contracts as these contracts are not traded in active markets therefore the IASB had decided in the 2013 ED to provide application guidance in the insurance contracts standard.

The Staff recommended that the IASB should confirm the proposals in the 2013 ED for the discount rates used to adjust the cash flows of an insurance contract and in addition clarify that this principle should be applied when there is a lack of observable data by recommending the use of judgement to:

a. ensure that appropriate adjustments are made to observable inputs to accommodate any different characteristics between prices from observed transactions and the insurance contracts being measured; and

b. 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. Accordingly, any unobservable inputs should not contradict any available and relevant market data.

IASB members confirmed their support to the refinements included in the Staff recommendations which were aimed at preserving the clarity that the measurement of each of the building blocks must make maximum use of observable data and minimise the use of non-observable market data at any time. There was some discussion about the use of market observable data if there were transactions in only one relevant bond. One IASB member stated that it would be necessary to explain the rationale for making adjustments to market observable data, and another commented that judgment becomes more relevant where there are few transactions. Another IASB member elaborated on the reason for the support to the Staff proposal noting that, although the IASB was not attempting to measure insurance contracts at fair value, many of the principles in IFRS 13 would still apply to the discount rate selection and it was appropriate that the final IFRS on insurance contracts incorporates them fully.

When called to vote by the Chairman, the IASB agreed unanimously with the Staff recommendations.

Asymmetrical treatment of gains from reinsurance contracts

The issue discussed was whether there should be an exception to the proposal in the 2013 ED that a favourable change in cash flows of a reinsurance contract held by an entity should be recognised in profit or loss over the coverage period even if those cash flows reimburse the entity for losses that arise from an underlying insurance contract that is onerous.

The IASB had concluded that the underlying direct insurance contract and the reinsurance contract are separate contracts. In the 2013 ED they changed their prior proposed approach to gain recognition on purchase of a reinsurance contract and decided that a cedant would not recognise a gain at inception of a reinsurance contract held.

The Staff set out in paper 2B that different considerations should apply after the contract is priced at initial recognition. In particular they support the view that changes in estimates of cash outflows on reinsured insurance contracts that trigger corresponding changes in cash inflows from a reinsurance contract should have no effect in profit or loss for the period. When the underlying insurance contracts become onerous, changes in estimates of cash flows are recognised in profit or loss and if reinsured it would appear appropriate that changes in estimates of cash flows in the reinsurance contracts held to cover those contracts now turned onerous should also be recognised in profit or loss so that they are treated in a consistent way.

The Staff recommended that an entity should recognise in profit or loss any changes in estimates of cash flows for a reinsurance contract held that arise as a result of changes in estimates of cash flows from reinsured insurance contract that are recognised immediately in profit or loss.

One IASB member noted that the relationship between reinsured insurance contracts and the related reinsurance contracts held is not straightforward, for example one reinsurance contract may cover one component of risk for many insurance contracts in reinsurers. The Staff responded that they had assumed that changes in reinsurance contract cash flows can be identified as these were linked to the reinsured insurance contract cash flows in the first instance and that this information would be readily available. Another IASB member commented that the trigger for adjusting the accounting for reinsurance contracts is the recognition of onerous direct insurance contracts.

When called to vote by the Chairman, the IASB agreed unanimously with the Staff recommendations.

Level of aggregation

This paper recommended clarification on the level of aggregation for measurement as proposed in the 2013 ED. In particular it recommended that the IASB:

a. 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.

b. Amend the definition of a portfolio of insurance contracts to "*insurance contracts that provide coverage for similar risks and are managed together as a single pool*".

c. Specify that:

    i. in determining the CSM or loss at initial recognition an entity should not combine onerous contracts with profit-making contracts.

    ii. 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.

Several IASB members commented that assumptions and other assessments are made at the portfolio level. There were some discussions on item (c)(ii) above relating to the criterion to have absolute amounts of CSM at initial recognition as one of the criteria to combine contracts for purposes of determining the CSM at subsequent measurement. The Staff explained that the criterion was introduced because if a portfolio has a majority of contracts with a small CSM and a minority of contracts with a large CSM (in absolute amount) it is possible for the majority of contracts with a small CSM to become onerous without turning the whole portfolio to an onerous portfolio status because of the large CSM balances having the capacity to absorb the losses from the contracts with small CSM. Similarly for the mere release to profit or loss of the CSM as a result of lapses the presence of different absolute amounts across the contracts in the portfolio it would prevent the insurer to use the passage of time as the earning pattern and it would require the insurer to include also the effect and expectation of lapses.

One IASB member expressed concern at adding a set of rules which he considered were unnecessary if the principles were set out clearly, particularly as such rules could lead to unintended consequences, but felt that the principles could be elaborated and guidance provided. Some IASB members expressed concerns about the IASB specifying that 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. The Staff stated if there was not support for this recommendation they would substitute examples that explained this principle.

When called to vote by the Chairman on recommendations (a), (b) and (c)(i) above 14 IASB members agreed with the Staff's recommendations and 2 disagreed.

When called to vote by the Chairman on recommendation (c)(ii) none of the IASB members agreed with the Staff's recommendations. When called to vote by the Chairman, after substituting the original recommendation (c)(ii) with the same concepts being illustrated as examples that explained the principle, 15 the IASB members agreed with the Staff's recommendations, with one IASB member voting against.

Selecting an accounting policy for presenting the effect of changes in discount rate

The Staff asked the IASB whether it agreed that, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, 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 to back the insurance liabilities associated with that portfolio.

IASB members expressed differing views on whether the clarification was helpful, or whether it merely repeated the requirements of IAS 8 thus appearing superfluous.

One IASB member commented that there would be lack of comparability as different insurers would be able to select different accounting policies in the same circumstances. Another IASB member commented that it was not always possible to identify the assets that back the insurance liabilities of a given portfolio. The Staff responded that it was necessary to consider the context in which those contracts are issued.

One IASB member suggested a change to the Staff's proposal such that it became "Does the IASB agree that, in accordance with IAS 8, 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 way the assets are accounted for". When called to vote by the Chairman on this modified recommendation, 10 IASB members agreed with the recommendation and 5 IASB members disagreed.

The identification of underlying items

This issue continued the IASB's discussions on the adaptations that might be needed for contracts with participating features by discussing the circumstances, if any, in which it would be appropriate for an entity to account for an insurance contract in a way that would rely on the identification of the underlying items. The Staff asked the IASB for tentative decisions for the purpose of directing the Staff future work.

When can the insurer's share be considered to be a 'fee' for the asset management services provided?

In the May 2014 education session the Staff explained two views of the insurer's share of the returns on underlying items being either akin to an implicit asset management fee that is based on the performance of underlying items, or as the insurer's economic interest in the underlying items. Because the accounting outcomes between these two positions are significantly different, it is important to clearly distinguish when each view applies. Applying the building blocks approach proposed by the IASB and the principle that the insurer's share of underlying items is an implicit fee for asset management services would result in changes in estimates of the insurer's share of underlying items adjusting the CSM. The CSM would still be recognised in profit or loss over the coverage period of the contract. In contrast, if the principle is that the insurer's share of underlying items is regarded as a change in the insurer's economic interest in the underlying items, changes in estimates of that economic interest should be recognised immediately in profit or loss. Paper 2D argued that adjusting the CSM for changes in estimates of the insurer's share of underlying items if it represents its economic interest in the underlying items would go beyond the proposals in the 2013 ED because these amounts do not relate to future service. Instead they relate to the insurer's current economic interest.

If the IASB were to require an entity to adjust the CSM for the insurer's share of the underlying items on the grounds that the insurer's share represents an implicit management fee, the Staff recommended that an implicit management fee should be considered to exist only when:

a. the returns pass 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;

b. there is a minimum amount (either fixed or determinable) that the entity must retain; and

c. the policyholder will receive a substantial share of the total return from the underlying items.

Several IASB members commented that they were concerned about addressing the issues in this order as it may send out a false signal about the IASB's intentions, as the IASB will be addressing the conceptual issues later.

One IASB member stated that the criteria included assets that the insurer chooses to hold, as well as those it was required to hold. He considered that the fee needed to be predefined and the policyholder had to have a substantial share in the underlying assets. Another IASB member stated that she had sympathy that the economics of being required to, and choosing to, hold assets were the same. Two IASB members expressed concern at the complexity of the proposed model. The Staff stated that guidance would need to be provided on what constituted a substantial share of the total return on underlying items.

Another IASB member expressed concern that if all adjustments were accounted for in the CSM, this would become a smoothing mechanism, and the net result would no longer be the main performance indicator for an insurer. One additional IASB member stated that he did not agree with Staff recommendation (b) as you could end up with different accounting for contracts (one that specified an explicit management fee, and another that did not) that were economically the same.

When called to vote by the Chairman, 11 IASB members agreed with (a) and (b) and 12 IASB members agreed with (c) of the above Staff recommendations.

What amounts should adjust the CSM?

There are differing views on the amount of the adjustment to the CSM, therefore the Staff asked IASB members for their views on the amounts that would adjust 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 of underlying items.

One IASB member expressed concerns about adjusting the CSM by the stand-alone selling price of the asset management service on both operational and conceptual grounds, and stated that she would prefer not to pursue this option. This view was supported by other IASB members, therefore the Staff agreed to focus on adjusting the CSM for changes in estimates of the insurer's share of underlying items, measured consistently with the measurement of the fulfilment cash flows or determined on a basis that reflects the effect of the equivalent changes in estimates of the underlying items in profit or loss.

Book yield approach

If the IASB were to require an entity to apply the book yield approach for determining the interest expense presented in profit or loss, the Staff recommended that the book yield approach should be applied only when:

a. the returns to be passed to the policyholder arise from the underlying items that the entity holds (regardless of whether the entity is required to hold those items); and

b. the policyholder will receive a substantial share of the total return on underlying items.

The Staff stated that this approach only related to presentation, not measurement, and was only relevant when the effect of changes in the discount rate were presented in OCI. The main difference between the book yield approach and the mirroring exception arises when underlying assets are measured at cost where the book yields approach keeps the measurement of the liability consistent with the building blocks approach that applies to all other insurance contracts.

One IASB member stated that he felt that the book yield approach was trying to achieve something similar to the OCI solution for non-participating contracts. Several IASB members stated that the book yield approach would add complexity, with two different discount rates, one to determine the balance sheet value and another for presentation purposes. The Staff confirmed that the book yield would have to be determined at each reporting date, and any difference between the interest charge in profit or loss and the impact of the discount rate in measuring the insurance contract liability would be included in OCI.

When is it appropriate to use the book yield approach?

If the IASB were to require an entity to apply the book yield approach for determining the interest expense in profit or loss, the Staff recommended that the book yield approach should be applied only when the returns to the 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 the policyholder will receive a substantial share of the total return on underlying items.

One IASB member stated that he did not agree with a view expressed in the paper 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.

Several IASB members expressed concern at the complexity of the proposed approach, together with the use of two approaches, being the book yield approach where the criteria for using such an approach were met, and the OCI approach for all other cases.

When called to vote by the Chairman, 12 IASB members agreed with the Staff recommendations.
