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Actuarial & Insurance Solutions

IFRS 4 Exposure Draft
Industry views

The revised Exposure Draft ED/2013/7 Insurance Contracts ("ED") was published for comment in June 2013 by the International Accounting Standards Board ("IASB"). Comments were due by 25 October 2013 and have been made available publically on the IFRS Foundation website. One hundred and ninety six comment letters were submitted by insurance companies, actuarial bodies (including the ASHK), accounting bodies, and industry groups.

As detailed in other Deloitte publications over recent months, there were seven areas that were open for comment. In this paper, we seek to summarize the comments submitted concerning these areas by various key insurance companies operating in the region, as well as the 'Big 4' accounting firms and the ASHK.

Question 1 — Adjusting the contractual service margin ("CSM")

Is it appropriate to adjust the CSM for changes to the estimates of the present value of future cash flows related to future coverage and services, while recognizing other changes immediately through profit and loss?

Exposure Draft Proposal

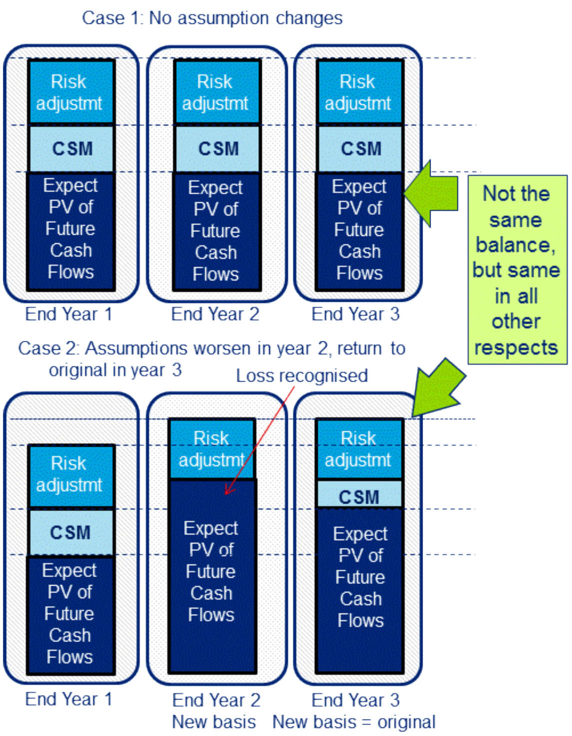
The CSM is a critical component of the building block approach ("BBA" - outlined in paragraphs 18-27) of the proposed accounting requirements. Designed as an unearned revenue balance to adjust profits over the *coverage period* based on the combined effect of a release pattern and the requirement to account for changes in assumptions related to future coverage periods, the CSM mechanism is a material difference from previous proposals. Originally calculated to eliminate the recognition of profits upon *initial recognition* (essentially inception date), the ED's first question seeks opinions on the manner in which this balance is carried forward throughout the *coverage period*.

A key change to the CSM introduced in this exposure draft is the requirement to unlock the CSM balance to reflect changes in future cash flows. In the previous exposure draft, the CSM amortization was locked-in and did not reflect changes to projected cash flows so changes flowed unmitigated into the P&L. With the revision, as long as the CSM is not lowered to zero at which it is floored, the CSM absorbs current impacts related to future coverage and services and then, as before, spreads the profits over the remaining contract's coverage period until a subsequent change in assumptions produces a new recalibration.

When losses are larger than the existing CSM (or the CSM is zero), "onerous" losses, the losses in excess of the CSM, immediately impact the P&L. If there is no CSM but changes to applicable cash flows would generate profits, a new CSM is established to once again be released in the future periods when coverage and other obligations are fulfilled. One pertinent intricacy of the approach is illustrated in the diagram below.

This diagram shows two cases assuming identical contracts. In the first case, the business is given the very simplifying assumption that the PVs of all components remain the same at the end of each year. The experience develops as expected and each component of the liability is the same at the end of each year. In the second case, future expectations change in both the second and third years. In the second year, changes increase the expected present value of future cash flows by an amount greater than the CSM, an onerous loss. This causes the CSM to be written off and a loss to be recognized in the year. In the third year, assumptions are again changed resulting in a present value of future cash flows in line with the original expectations. In this case, no profit is recognized from the change in projected cash flows and the full change in cash flows is used to increase the CSM.

Diagram 1 – Impacts to the CSM



While the expected present values of the cash flows are similar in year 3 under both cases, the total liability held is different. We refer to this phenomenon as a "path-dependent" balance.

Comment Letter Summary

The respondents reviewed universally supported the main ideas of the proposed unlocking approach. However, that is not to say that the responders felt the approach was now ideal.

The mechanics of the unlocking generated responses focused on four main areas of concern: what cash flows were allowed to adjust the CSM, the treatment of onerous losses and subsequent gains, the unit of account for the CSM, and the discount rate to be used for the CSM.

The determination of which cash flows are allowed to impact the CSM were the most commonly discussed element within this question. At a minimum, the definition of what cash flows are and are not proposed to affect the CSM needs clarification. Many took stronger stances and felt that various changes in cash flows that were excluded (e.g. recognized immediately in P&L) should be included when adjusting the CSM. In particular, it was considered more appropriate to reflect changes to the *risk adjustment* in the CSM. While some other specific cash flows that are currently excluded were mentioned, it was clear that most found the restrictions, just that, restrictive and none of the responses we read suggested strengthening restrictions. In line with this concept, a comment was made that changes in the timing of cash flows (as discussed in paragraph B68(c)) should also be allowed to impact the CSM as they change the present value.

The treatment of onerous losses subsequently followed by favourable changes to applicable cash flows was also repeatedly discussed in the comment letters. As illustrated in the diagram above, path-dependent liabilities were felt to be inappropriate by numerous respondents. It was commonly suggested that onerous loss amounts passed through the P&L should be used to offset favourable cash flow changes if and when such favourable changes occurred.

Use of *portfolios* (per Appendix A of the ED) as the unit of account at which the CSM was calculated was noted by several respondents as inappropriate. However, there was no consensus on what the right answer was in the responses, as the suggestions included calls for increased granularity, consistency with how the business was managed, and reduced granularity.

Lastly, comments on the discount rate to be used occurred consistently throughout the responses. Currently the CSM is to be accreted using the interest rate at *initial recognition*. Closely tied to the answers to question 4 (as discussed below), most respondents felt that rates used should be consistent with the rates used for other elements of the liabilities for P&L purposes; i.e. if Other Comprehensive Income ("OCI") is not applicable and the liabilities are reported as fair value through the P&L, then the CSM should accrete at market rates.

A few other suggestions of note considered the mechanics of the amortization of the CSM. While not considered by the majority of the respondents, suggestions included extending the CSM amortization period to include the settlement period in addition to the *coverage period*, that the pattern of amortization should be clearly defined as straight-line for consistency, and that the pattern of amortization should remain open to determination by the companies as proposed in the exposure draft.

Question 2 — Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires payments to policyholders that are linked to the returns of specified underlying items should:

a) The value of fulfilment cash flows directly linked should be valued in line with the carrying value of the underlying items, and
b) The value of fulfilment cash flows not directly linked should be valued in line with the proposed BBA methodology?

Furthermore, should changes to fulfilment cash flows that are:

a) Directly linked flow through P&L or OCI consistently with the underlying items,
b) Indirectly linked flow through P&L, and
c) Not linked (e.g. mortality, expenses) flow through P&L or OCI in accordance with the standard BBA approach?

Exposure Draft Proposal

Conceptually, the purpose of the proposed requirements is to align the value of contracts with cash flows dependent on or "linked" to specified underlying items (per ED paragraph 33) with the value of those underlying items. These contracts are commonly referred to in the comment letters as "mirrored contracts". Based on comment letter responses, the definition of the business covered by these provisions is written so that two main categories of policies are expected to be impacted in Asia, unit-linked or variable products and participating products.

The guidance requires splitting the projected cash flows into three components: cash flows directly linked to the specified items, cash flows indirectly linked to the specified items (generally interpreted as cash flows resulting from options and guarantees), and cash flows not linked to the specified items. The cash flows not linked to the specified items are those considered to be linked to other factors like mortality, lapses, expenses, etc.

The directly linked component is then valued and reflected in the P&L or OCI in line with the carrying value of the corresponding specified items. The indirectly linked component is valued using a BBA approach with all changes to the value reflected immediately through P&L. The remaining component would follow the more traditional BBA reserving requirements as outlined in the exposure draft. Changes in prospective cash flows within this final component are absorbed by the CSM, to the extent possible. Neither of the other cash flow components described above trigger unlocking of the CSM.

Comment Letter Summary

Arguably, one of the most complicated components of the exposure draft, the treatment of mirrored contracts was certainly one of the most contested. While some respondents felt that the principle of relating the liabilities directly to the carrying value of underlying items was sound, the application was almost universally considered inappropriate. Two common concerns were the inherent interdependencies of the projected cash flows and the subjectivity of cash flow segmentation which would lead to inconsistent application.

Certain classes of contracts, commonly referred to as participating business here in Asia, that pass investment experience to policyholders while also passing the costs of other risks, such as mortality, morbidity, lapses, expenses, or some combination thereof, are interpreted by respondents as falling under the guidance that requires segmentation of cash flows. Most respondents felt that for this class of products the cash flows were too interdependent and any segmentation of cash flows was an artificial construct and not representative of the realities of the contracts. Given this fundamental interdependency, the required segmentation of the cash flows for these products was considered inappropriate.

Those respondents that supported the principle of directly relating reported values to the carrying value of the specified underlying items still felt that the complexities inherent in the segmentation of the cash flows in these participating contracts would prove operationally intractable. Maintaining principle-focused, i.e. non-prescriptive, yet clear guidance for the variety of products and designs available in the global market was felt to be impractical. The resulting interpretation of methodology used to segment cash flows as prescribed was deemed likely to result in significant variance in reporting by companies with economically similar contracts.

Whether in support of "mirroring" or not, almost all respondents suggested that segmentation of projected cash flows for these contracts should be eliminated.

It was felt that the contracts should be treated holistically in an approach more closely aligned to the BBA approach.

Again, while not consistently included by the respondents, a few responses discussed tangential topics for participating contracts. Comments included the concept of the "floating CSM", reflecting shareholder interests in par funds in the CSM in line with the spirit of the unearned revenue concept underlying the CSM, and reflecting the link between fund earned rates and discount rates in accounting for asset dependent cash flows.

Question 3 — Presentation of insurance contract revenue and expenses

Should financial statements presents, in profit or loss, insurance contract revenue and expenses rather the changes in the components of the insurance contracts?

Exposure Draft Proposal

The proposed revenue recognition presentation outlined in the exposure draft was designed to provide for the intricacies of insurance products while staying as aligned as possible with the general revenue recognition guidance inherent in the universe of IFRS standards (see Diagram 2). This approach was proposed in order to improve consistency with other industries and thus generate more directly comparable financials across insurance and non-insurance entities alike.

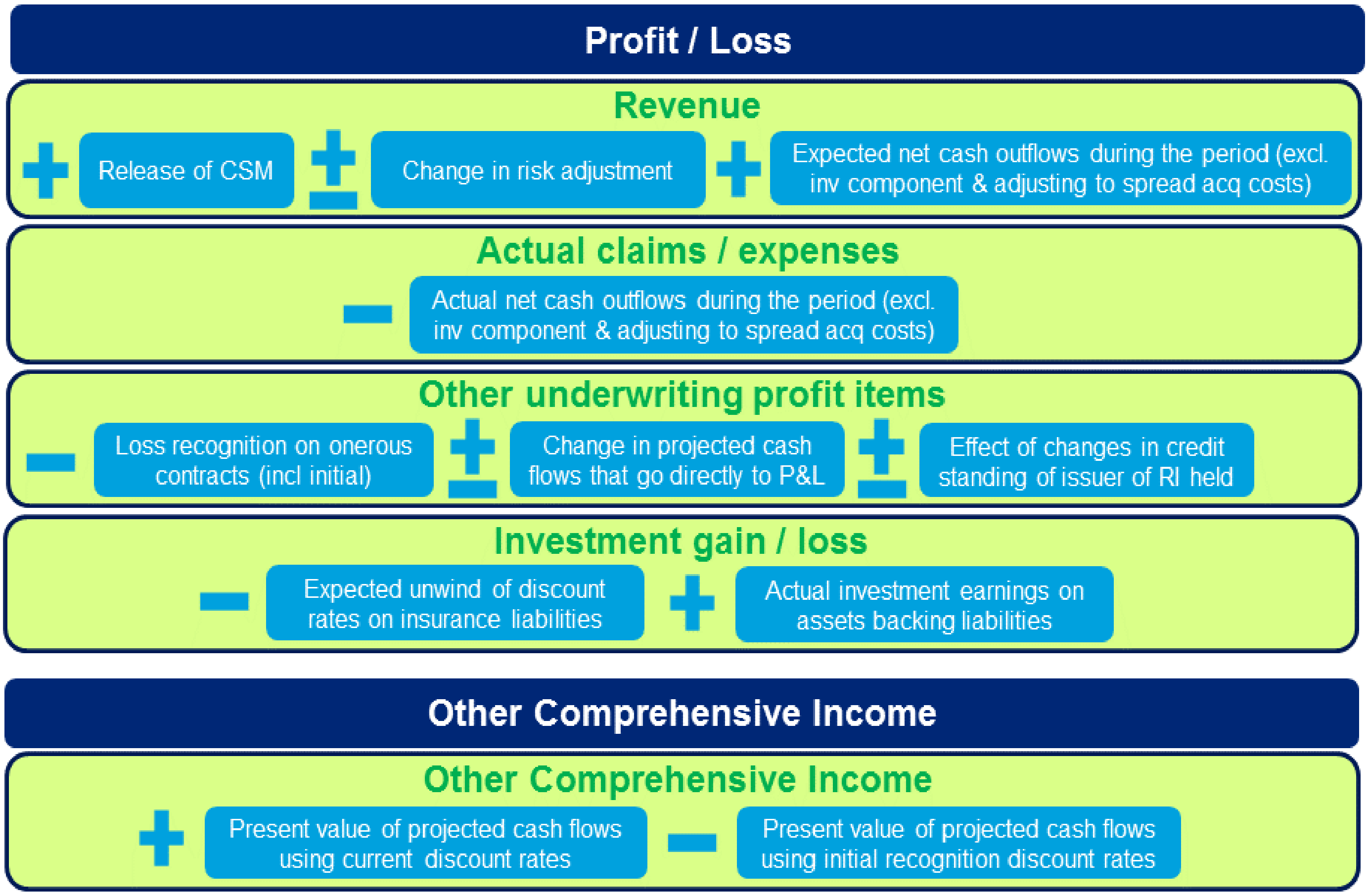
Comment Letter Summary

Despite a uniform disapproval of the approach, there was little overlap in the suggestions for a solution.

Support for principle of attempting to align with IFRS general revenue recognition principles was also mixed. Some disagreed with the approach conceptually, feeling that such an alignment was poorly conceived. One respondent provided the concise argument that the very existence of IFRS 4 was necessitated by the differences in the nature of insurance business and that if the general approach was appropriate you wouldn't need IFRS 4 in the first place. At the other end of the spectrum, another respondent applauded the attempt of the draft to achieve such alignment as the resulting comparability would be a valuable outcome.

However, all respondents agreed that the exposure draft's presentation was not appropriate in its current form. Complexity and cost were the most common concerns. A prominent third theme was the value of the information provided. Presentations utilised under current reporting bases were commonly compared favourably to the proposal while some used colourful phrases such as "questionable … decision-usefulness" to describe the approach.

Diagram 2 – IFRS 4 Revenue Recognition



Often, proposed alternatives weren't provided, but those respondents with suggestions provided various options including reconciliations to traditional volume measures, presenting gross premiums consistent with existing IFRS, and utilizing an alternative presentation being developed by the American Council of Life Insurers.

Should underwriting performance and changes to discount rates be separated by recognizing through the P&L the Question 4 — Interest expense in profit or loss interest expense "using the discount rates that applied at the date that the contract was initially recognized" and by recognizing through OCI the difference between the carrying amount determined by "discount rates that applied at the reporting date" and the carrying amount determined by the rates used for interest expense?

Exposure Draft Proposal

Simply put, the ED proposes to reflect changes to the book value of the liabilities through P&L with a market value adjustment flowing through OCI directly to Shareholder's Equity. Using interest rates that "applied at the date that the contract was initially recognized" for P&L purposes and allowing the change in liability from changes in current rates to be recognized in OCI was designed to match the recognition of liability changes with the corresponding changes to assets held in support of the same (see Diagram 3). This valuation approach is commonly abbreviated as FVTOCI compared to FVTPL (or fair value through P&L) where full market value changes are recognized immediately through the P&L.

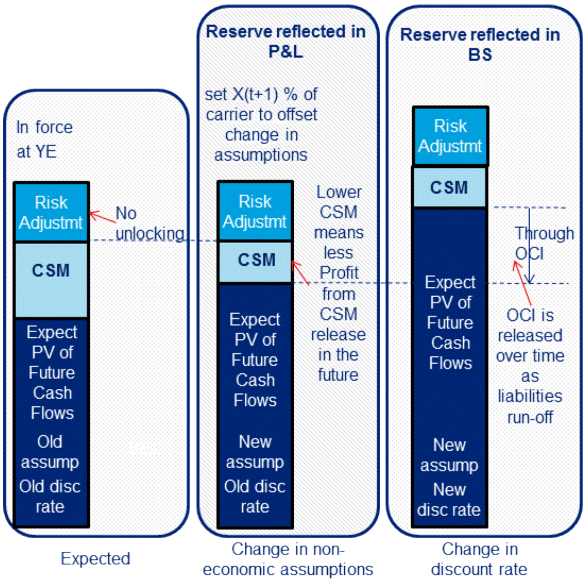
Comment Letter Summary

Respondents felt this approach was not reflective of reality as Asian insurance companies invest in a broader range of assets than fixed interest securities which are assumed to be held at FVTOCI. Given common investments in equities, real estate, and even derivatives, FVTOCI was expected to result in significant volatility via asset accounting mismatches if made mandatory as the current exposure draft requires.

Proposals to make FVTOCI optional (FVTPL being the other option) were nearly universal with the added suggestion from several respondents that the option should be made at inception of the business and irrevocable to avoid abuse.

This was proposed to allow companies to more closely align their liability accounting with the accounting of the underlying assets.

Diagram 3 – OCI Effects



A notable exception in this category was that one company we reviewed aligned with Stephen Cooper (the only dissenting IASB member to the publication of the exposure draft) and stated the entire OCI approach was flawed and all asset and liability values should be reported at fair value at all times. Several companies also suggested revisions to existing hedging rules to more closely match asset and liability accounting as well.

Tangential to the OCI discussion, several companies suggested that using a long-term average rate for long-term rates (when observable market data was absent or unreliable) was appropriate and necessary to reflect the economics of the business and to reduce unjustifiable volatility.

Question 5 — Effective date and transition

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

Exposure Draft Proposal

Upon transition, the requirements are proposed to retrospectively apply to all business in-force at that time. The proposed implementation period is three years from final approval of the standard to allow companies to prepare and create the infrastructure to effectively report under the requirements. To facilitate ease of transition, provisions allow for expediency measures in instances where historical data is not readily available for a full theoretically accurate valuation of existing, ostensibly older, blocks of business.

Comment Letter Summary

The retrospective nature of the transition and the included expediency provisions were often favourably referenced in the responses. Several respondents suggested further increasing the expediency measures to allow application to a broader set of business.

An important concern on the minds of the respondents was alignment with IFRS 9 and its corresponding asset classification.

While alignment in terms of timing was suggested by several respondents, in its absence, optional asset reclassification at the time of IFRS 4 adoption was felt to be a reasonable alternative.

The 3 year transition period was felt to be acceptable as a minimum by most respondents, but suggestions to extend the period for another exposure period with more field testing were also not uncommon.

Question 6 — The likely effects of a Standard for insurance contracts

As a whole, how do the costs compare to the benefits for the proposed requirements, particularly considering transparency and the compliance costs of transition and an ongoing basis?

Whether adoption would be positive or negative overall varied by respondent.

All respondents felt it would be complex and costly to implement, but whether this cost will come with improved transparency and comparability or a regime fraught with accounting mistakes will have to be determined upon adoption.

Related to question 3, several respondents felt that presentation will be one of the more onerous elements to implement.

Question 7 — Clarity of drafting

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

Clarification was felt by most to be required in numerous and varying areas.

A common thread amongst respondents was the call for an increased set of illustrative examples.

The ability of the proposals to reflect the decisions by the IASB appeared to be largely ignored by respondents.

Contact Information

If you have any questions or comments on this paper or would like to discuss any other aspect of IFRS, please feel free contact one of the consultants below or your usual Deloitte consultant.

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