The IASB has completed its deliberations on IFRS 4 Phase II

Last set of decisions on unit of account and indirect par

Francesco Nagari
Deloitte Global IFRS Insurance Lead Partner
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Agenda

- **Highlights of the IASB meeting on 19-20 January 2016**
- **IASB Staff analysis, IASB discussion and tentative decisions**
- **Next steps**

Highlights

- This meeting has been declared to be **the last substantive discussion meeting on the project for the new IFRS on Insurance Contracts**. As anticipated the decisions on unit of account and on indirect participation contracts were debated and voted
- The first key decision on the unit of account is that the portfolios of contracts with **similar risks** will have to be subdivided in separate groups if there are **different levels of expected profitability at inception**. Even when such diversity of expected profitability is caused by **regulation**.
- The second key decision is that insurers can use these units of account to release the CSM to profit or loss but need to respect the principle that **derecognition of contracts releases any residual CSM to profit or loss.**
- The solution to the indirect participating contracts is not to include them in the scope of the VFA. Instead, the **CSM will be unlocked** when the insurer **changes the expected level of policyholder bonuses established at inception**. Other changes from market variables will go through P&L or OCI.

Level of aggregation

Overview of the issues discussed in paper 2A and its addendum

- The level of aggregation needs to be considered because in some circumstances gains are treated differently to losses, therefore **an accounting mismatch may be created if contracts were accounted for individually**.

- An entity would **recognise a positive CSM over the coverage period, but recognise a negative CSM immediately in profit or loss**. There may also be other differences in the treatment of gains and losses in allocating the CSM.

Onerous contracts

- To avoid recognising losses that arise on individual contracts because events affect individual contracts differently, the Staff thinks **the level of aggregation should be specified** to determine whether a group of contracts is onerous.

Allocation of the CSM

- For contracts where the coverage period ends earlier than the average coverage period of the group, measuring contracts **individually would mean that the associated CSM would be recognised in profit or loss up to the point when the coverage period ends,** whereas this **may not necessarily the case where they are measured on a group basis.**

Level of aggregation

Overview of the issues discussed in paper 2A and its addendum (continued)

Exception for the effect of regulation

- The level of aggregation proposed in the paper requires that a group should comprise contracts that on inception have similar expected profitability.
- Regulation may affect the pricing of insurance contracts, and some suggest that an exception should be provided in determining the level of aggregation for contracts for which an entity does not have the right or practical ability to set a price that fully reflects the risk of that particular policyholder, to avoid recognising losses for one group of policyholders
- The Staff does not recommend making an exception because a difference in profitability is a real economic difference between contracts, which provides information that should not be lost

Level of aggregation for onerous contracts

Staff recommendation – onerous contracts

- A loss for onerous contracts should be required to be recognised only when the CSM is negative for a group of contracts, and that the group should comprise contracts that **at inception**:
  a) have cash flows that the entity expects will **respond in similar ways to key drivers of risk in terms of amount and timing**; and
  b) had **similar expected profitability** (i.e. similar CSM as a percentage of the premium)

Level of aggregation for onerous contracts

IASB discussion

IASB discussion

The discussion was lively and several comments were made. The more notable ones are:

- The recommendation was deemed rather prescriptive and rules-based, a principles-based approach would have been preferable.
- The recommendation seems to move the new IFRS towards consistency with IFRS 15, this was seen as positive
- This level of aggregation was deemed to faithfully reflect the business model of insurers.
- If claims experience worsened significantly after inception for a sub-set of contracts in the group, these contracts should be put into a separate group

Level of aggregation for onerous contracts

IASB discussion and decision

IASB discussion

- The word ‘similar’ could result in different interpretations of the requirement for the expected profitability.
- The possibility that marginally loss making contracts would be grouped separately from profitable contracts even if the other features were the same was debated as a result of the requirement and whether it would be an appropriate representation.
- The Staff stated that ‘similar profitability’ required judgement, and there would be guidance on the allocation of costs.
- The final text of the new IFRS should include examples of what is meant by ‘similar expected profitability’.

IASB tentative decision

- The Board unanimously approved the Staff recommendation.

Level of aggregation for the allocation of the CSM

Staff recommendation – allocation (Revised from 2A in the addendum)

a) The objective of the allocation of the CSM is to recognise the CSM for **an individual contract** in profit or loss over the coverage period of the contract in a way that best reflects the service to be provided by the contract. Hence, if there is no more service to be provided by a contract after the end of the reporting period, the CSM for that contract should have been fully recognised in profit or loss.

b) An entity can group contracts for allocating the CSM provided that the allocation of the CSM for the group meets the objective in (a).

c) An entity that groups contracts is deemed to meet the objective in (a) provided that:

   i. The contracts in the group have cash flows that the entity expects will respond in similar ways to key drivers of risk in terms of amount and timing; and on inception had similar expected profitability (i.e. similar CSM as a percentage of the premium); and
   ii. The entity **adjusts the allocation** of the CSM for the group **in the period** to reflect the **expected duration** and **size** of the **contracts remaining after the end of the period**.

Level of aggregation for the allocation of the CSM

IASB discussion

IASB discussion

- There was some discussion about a different recommendation of the Staff presented on 19 January with a third criteria under (c) that was subsequently modified.
- The debate led the Board to require the removal of the criterion to group contracts with similar expected coverage periods. Instead that was turned in the guidance on the mechanics of allocation (reference to “expected duration”)
- The text in the previous slide is the amended recommendation discussed the next day (20 January).
- The Board members agreed that the new Standard requires different levels of aggregation for different purposes.
- For example, the level of aggregation for onerous contracts would be met by criteria in paragraph (c)(i). However, the number of contracts to determine the risk adjustment can be much greater than in the number included in the group for onerous contract testing.

Level of aggregation for the allocation of the CSM

IASB discussion and decision

IASB discussion (continued)

- The Staff view is there is no need to track individual contracts but the group needs to be adjusted if the entity is aware the contracts in the group behave differently.
- Some Board members had reservations about a reference to individual contract in the objective.
- The Staff stated that the allocation would be made at a group level, but the objective applied to each contract. Nonetheless, Board agreed to state ‘individual contract, **or group of homogeneous contracts**,’ to the objective.

IASB tentative decision

- The Board agreed that the wording would need to be revised, but voted 12 against 2 to support the Staff recommendation, as amended.

Exception for the effect of regulation

Staff recommendation

- There should be no exception to the level of aggregation for determining onerous contracts or the allocation of the CSM when regulation affects the pricing of contracts. Groups of contracts that have dissimilar expected profitability as a result of regulation cannot be grouped together for onerous contracts testing and allocation.

Exception for the effect of regulation

IASB discussion and decision

IASB discussion

- The recommendation provoked a lively debate. Gender equality regulations were considered. Under these regulations insurers need to charge the same premium to male and female policyholders even if the risks may be statistically different.
- Premiums paid by female policyholders may be subsidising claims incurred by male policyholders but the risk and overall portfolio profitability remain the same. Viewed as two separate portfolios the CSM of the female policyholders would be higher, whereas the male policyholders may result in a group of onerous contracts.
- Some viewed this as not reflecting the economic substance whereas others viewed it as appropriately highlighting the different profitability of the two portfolios.
- A minority of Board members noted that this required defining what ‘regulation’ was and that it would create an undesirable precedent for other industries.

IASB tentative decision

- The Board approved the Staff recommendation with 10 members voting for and 4 against.

Specifying the effect of discretion in the general model

Overview

- The effect of **discretion for participating contracts which do not meet the definition of direct participating contracts** (to which the variable fee approach should be applied).
- At the November 2015 meeting the Board considered 4 ways to distinguish changes caused by market variables and changes in discretionary cash flows. At that meeting the Staff recommended using the market as a benchmark to determine the effect of discretion, but some **Board members suggested an approach that took into account also the insurer's expected level of discretion**.
- The Staff explained in the January 2016 paper that **such an approach would require an entity to specify at the inception of a contract how it viewed its discretion**, and **to use that specification to distinguish between the effect of changes in market variables and changes in discretion**.
- The Staff commented that there are **two finely balanced viable alternatives**, which it asked the Board to consider.

Specifying the effect of discretion in the general model

Staff question

- Does the Board wish to proceed by requiring:
    a) an entity to specify the effect of discretion at inception; or
    b) an entity to determine the effect of discretion by reference to the market in each reporting period?

Specifying the effect of discretion in the general model

IASB discussion and decision

IASB discussion

- Alternative (a) provides useful information on the targeted rate of return payable to the policyholders. The debate confirmed the view that in many cases it is possible to identify the effect on the fulfilment cash flows arising from changes in market variables.
- In conclusion the Board decided to adopt both alternatives with the reference to the current market return of the contract becoming the default benchmark if the insurer is unable to specify in advance how it will determine the discretionary amounts due to policyholders.
- Changes on the expected levels of discretionary bonuses would then adjust the CSM while all other changes caused by market variables will be accounted for in P&L or OCI in line with the presentation of the effects of the discount rate

IASB tentative decision

- The Board unanimously approved to merge in a single combined accounting approach the two Staff alternatives.

Insurance contracts - Next steps

Remaining technical decisions and publication date

- The ballot papers (2C and 2D) state that the proposals for accounting for insurance contracts are **sufficiently developed to begin the balloting process**. In addition they state that the Board **complied with all of the required steps in its *Due Process Handbook***.

- At the February 2016 meeting the Staff expects to ask the Board:

  a) To formally review the **due process steps** that it has taken in developing the new insurance contracts Standard and confirm that it is satisfied that the Board has completed them; and

  b) To grant the Staff permission to begin the **balloting process**.

- The effective date is likely to be decided during the balloting process emulating the approach that was adopted to finalise IFRS 16 *Leases*

- The target publication date of what is likely to become IFRS 17 *Insurance Contracts* is the end of 2016. IFRS 4 will remain in place till IFRS 17 is mandatorily effective and it will contain the provisions on the IFRS 9 decoupling.

Contact details

Francesco Nagari
Deloitte Global IFRS Insurance Lead Partner
+852 2852 1977 fnagari@deloitte.co.uk

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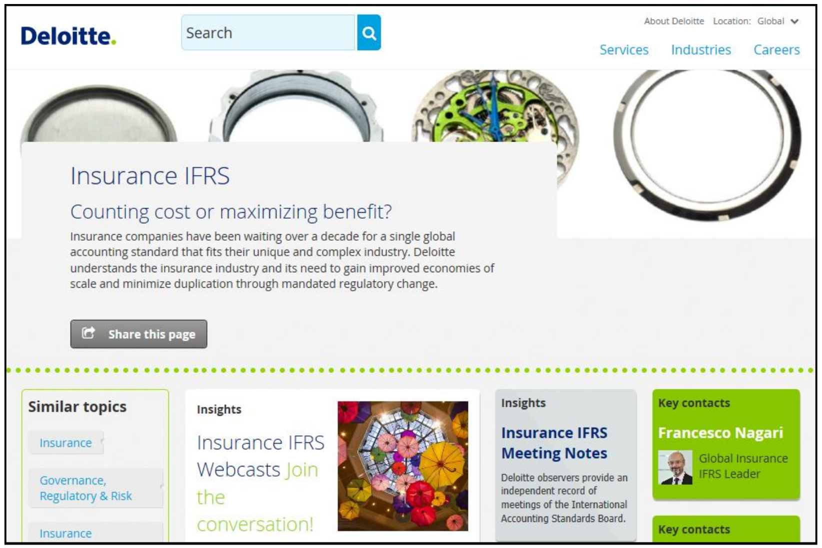

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