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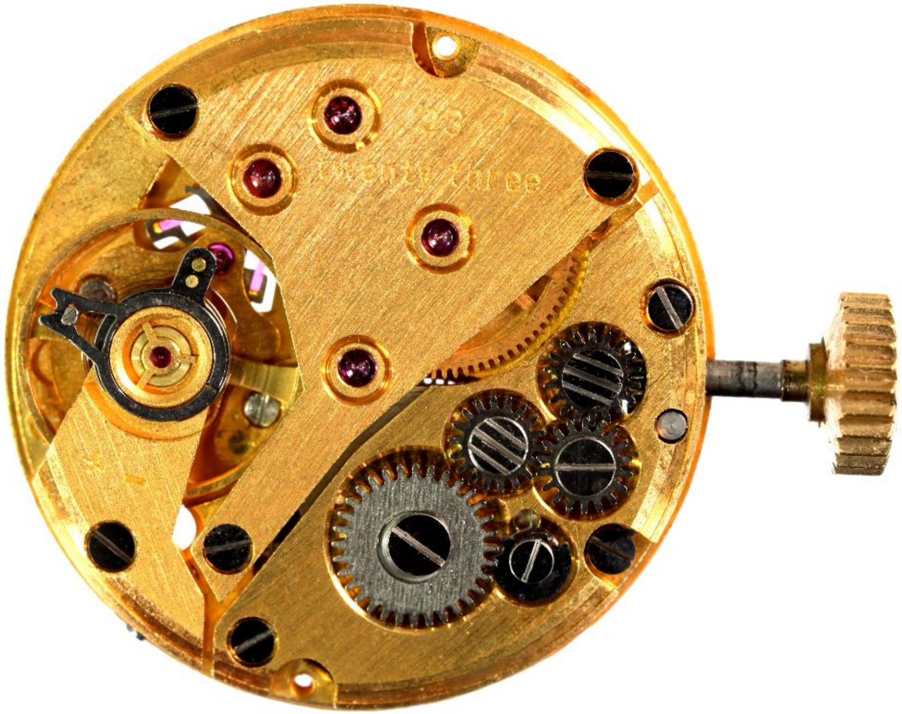

IASB votes on sweep issues for IFRS 4 Phase II and nears completion

IASB will select the effective date for the new IFRS in Q3

Francesco Nagari, Deloitte Global IFRS Insurance Leader | 28 June 2016

Agenda

- Highlights of the IASB meeting on 22 June 2016
- IASB Staff analysis, IASB discussion and tentative decisions
- Next steps

Highlights of June IASB meeting

- On 22 June 2016 the IASB voted on four sweep issues:
  - CSM unlocking and allocation to P&L must only be done on a group basis. Groups are open to new contracts subject to strict tests
  - Develop guidance on the accounting between P&L and CSM for changes that respectively relate to current and future coverage periods
  - Abandoned the requirement in the OCI solution to use a "cost measurement basis" in P&L for finance cost and income and adopt instead a "systematic basis". Disclosures on interest expense will be simplified
  - Amend the scope of the Variable Fee Approach (VFA) to exclude reinsurance contracts issued and held
- Fatal flaw review will kick off soon with the new draft incorporating these decisions
- IASB will be called to choose the effective date in September 2016
- IFRS 4 Phase II could be issued by the end of 2016 and it will become IFRS 17 *Insurance Contracts*

Level of aggregation in measuring the CSM

Staff analysis – Subsequent measurement of the CSM

- **The level of aggregation was previously considered separately for the adjustments to the CSM arising from changes in estimates and for the allocation of the CSM to profit or loss**

  The sweep issue is whether those effects should be considered together because of their interaction and given that there are differences between measuring contracts on a group basis and on an individual contract basis

- **On an individual contract basis the CSM for each contract would be recognised in profit or loss in proportion to the expected duration of the contract**
- **On a group basis, when one contract has lapsed and the group behaved as expected the total CSM will be recognised in profit or loss in proportion to the expected length of the contracts within the group. That would be a different impact on P&L**
- **The Staff did not intend when setting the objective as the measurement of individual contracts to give rise to a different accounting result when the group behaves as expected**

Level of aggregation in measuring the CSM

Staff analysis – Adding contracts to the group in later periods

- The Staff believe that an entity should be able to add contracts that at their inception are similar to the characteristics of the group at the date the contract joins the group. This means that groups are open-ended
- The contract can be added to an existing group when it has:
  - cash flows that the entity expects will respond in similar ways to changes in key assumptions in terms of amount and timing; and
  - similar profitability
- The new contract must be similar to the group as it currently is, not as the group was when it started
- This was not offered to the IASB for deliberation but it appeared to have been reported in a fairly definitive way
- The closing comment in the Staff paper is that "new contracts will often not meet the criteria for joining the group"

Level of aggregation in measuring the CSM

Staff recommendation

- The Staff recommends that the objective for the adjustment and release of the CSM is that the CSM at the end of the reporting period represents the profit for the future services to be provided for a group of contracts
- They recommend that there is specification that the group of contracts used for measuring the CSM should be the same as the group used for determining when contracts are onerous
- They recommend that an entity should therefore measure the CSM by grouping insurance contracts that at inception have:
  a. Expected cash flows that the entity expects will respond in similar ways to changes in key assumptions in terms of amount and timing
  b. Similar expected profitability, i.e. CSM as a percentage of the total expected revenue. An entity can use expected premiums as a practical expedient
- An entity should release CSM in P&L to reflect the expected duration and size of the contracts remaining at the end of the period in the group

Level of aggregation in measuring the CSM

IASB discussion and tentative decision

- General agreement with removing the reference to individual contracts
- Some Board members raised their concern that the objective would result in thousands of portfolios in many cases, therefore it would be better to group contracts in a way that reflects the way in which the company manages its business
- It is important to state what is intended by the term "similar profitability" as this is open to a wide range of interpretations
- There will be a lot of push back, but compared with the way banks will be recognising credit losses as a result of the requirements of IFRS 9 this is equivalent
- The Board was convinced that better accounting will result in better business practices

Tentative decision

- The Board approved by 11 votes for and 3 votes against the Staff recommendation

Changes in the carrying amount of the CSM for insurance contracts without direct participation features
Staff analysis

- Under the general model, the CSM is adjusted for changes in the fulfilment cash flows that relate to future service
- The guidance in the 2013 Exposure Draft describes some specific cases, but does not set out a general approach beyond the overall objective. It also failed to lead to a clear common understanding of what changes would adjust the CSM
- The text does not change the substance of the requirements in the 2013 Exposure Draft, in particular the objective of distinguishing changes relating to future service from changes relating to current or past service
- Following the objective may indicate that the experience adjustment and the change in future estimates should not be combined
- However, the Staff thinks that recognising a gain or loss in the current period knowing that there will be a consequential loss or gain in the future would not give a faithful representation of the single event

Changes in the carrying amount of the CSM for insurance contracts without direct participation features

Staff recommendation

The Staff recommended that the new IFRS should provide guidance on:

- **what changes in the fulfilment cash flows relate to future service, and hence adjust the CSM, and**
- **what changes relate to current and past service, and hence do not adjust the CSM**

Changes in the carrying amount of the CSM for insurance contracts without direct participation features

IASB discussion and tentative decision

- Disagreement with the wording of the proposal, as where an event had occurred in the current period that resulted in changes to the estimate of cash flows, this would result in too much of this change in estimates being reflected in the future (by adjusting the CSM), and too little in the current period
- The staff agreed that greater clarity was required by what was meant by an "incurred claim", and they will change the wording in respect of "experience adjustments" to make the intention clearer
- Minor revisions to the proposed wording suggested, which the Staff agreed to consider. An appendix to a revised paper 2B which contains the approved text is available for download in the IASB website

Tentative decision

- The Board approved by 12 votes for and 2 votes against the Staff recommendation

Presentation and disclosure of finance income or expenses

Staff analysis – Disaggregating a change in the risk adjustment to present a finance component and an underwriting component

- Insurance finance income or expenses are likely to have a significant effect on the performance of an insurer, particularly one that issues long duration contracts
- Insurance finance income or expenses are defined as:
  - the change in the effect of the time value of money arising from the passage of time; and
  - the effect of changes in financial assumptions (namely the current discount rate)
- These include changes in the present value of the future cash flows, the risk adjustment and the CSM
- It is not feasible to precisely identify the effect of changes in discount rate on the risk adjustment given the different techniques for measuring the risk adjustment some of which may not explicitly consider time value of money

Presentation and disclosure of finance income or expenses

Staff analysis – Presentation of insurance finance income or expenses for contracts not eligible for the current period book yield approach

– The IASB decision to use a cost basis when the OCI solution is adopted for asset-dependent cash flow contracts is inconsistent with use of the term 'cost' in other IFRS, e.g. using crediting rates that do not approximate to the effective yield

– Where changes in financial assumptions have a substantial effect on the amounts paid to policyholders, a systematic allocation can be determined in different ways

– Many of these ways are not cost measurement bases.

– The amounts credited to policyholders are expected to primarily be driven by economic factors. Often these amounts would be deemed those for P&L presentation when the OCI solution is adopted

– Placing restrictions on amounts credited in a period by stating a cost measurement principle would add complexity and carry significant risk of causing unintended consequences

Presentation and disclosure of finance income or expenses

Staff analysis – Disclosures relating to insurance finance income or expenses

- The Staff are not aware of a reliable and practical method to separate the effect of accreting at current discount rates and changes in rates from the other factors for contracts with participation features
- In addition, rather than specify a detailed disclosure that is only applicable in some circumstances certain proposed disclosure requirements should be deleted

Presentation and disclosure of finance income or expenses

Staff recommendation

The Staff recommended that:

A. An entity need not disaggregate the change in the risk adjustment into a finance component and an underwriting component.

B. If the entity does not make such a disaggregation, it should present the entire change in the risk adjustment as part of the underwriting result. Disclosure would be required to explain the choice made.

C. If an entity disaggregates insurance finance income and expenses of a contract for the period between P&L and OCI, the standard should:

- ***not specify*** **the objective of disaggregating finance income or expenses as being to present insurance finance income or expenses in P&L on a cost measurement basis;**
- ***instead*** **specify that the entity should present in P&L a systematic allocation of the total expected insurance finance income or expenses over the life of the contract.**

Presentation and disclosure of finance income or expenses

Staff recommendation

D. The standard should provide guidance that, in this context, a systematic allocation is:

- **based on characteristics of the contract without reference to factors that do not affect the measurement of the contract, and**
- **results in the amounts recognised in OCI over the life of the contract totalling zero.**

Presentation and disclosure of finance income or expenses

Staff recommendation

E. **The standard should provide further guidance that:**

- **for insurance contracts for which changes in financial assumptions do not have a substantial effect on the amounts paid to the policyholder**
  - **The systematic allocation is determined using the discount rate(s) applicable at the inception of the contract (the locked-in rate); and**
- **for insurance contracts for which changes in financial assumptions have a substantial effect on the amounts paid to the policyholder the systematic allocation can be determined in different ways**
  - **Using a rate that allocates the remaining revised expected finance expenses over the remaining life of the contract at a constant rate, or**
  - **For contracts that use a crediting rate to determine amounts due to the policyholder, using an allocation that is based on the amounts credited in the period and expected to be credited in future periods.**

Presentation and disclosure of finance income or expenses

Staff recommendation

F. **The standard will abandon the disclosure on the composition of the interest expense and instead it will ask an insurer to disclose:**

- **The relationship between insurance finance income and expenses and the investment return on the related assets, and**
- **The methods used to calculate the interest expense in P&L**

Presentation and disclosure of finance income or expenses

IASB discussion and tentative decision

- There was general agreement with the proposals, subject to minor suggestions for improving the wording.

Tentative decisions

- The Board unanimously approved most of the Staff recommendations (A to E), and approved by 12 votes for and 2 vote against the last staff recommendation (F).

Reinsurance contracts and the scope of the VFA

Staff analysis

- Some types of reinsurance contracts issued might meet the VFA criteria as currently drafted.
- A reinsurance contract always specifies a clearly identified pool of underlying items, namely the direct insurance contracts that are reinsured. Thus the entity would be required to apply the VFA to reinsurance contracts if the following conditions are met:
  - the cedant participates in a share of the reinsured direct insurance contracts;
  - the reinsurer expects that the cedant will retain a substantial share of the returns from the reinsured direct insurance contracts; and
  - a substantial proportion of the cash flows that the reinsurer expects the cedant to retain are expected to vary with the cash flows from reinsured direct insurance contracts.

Reinsurance contracts and the scope of the VFA

Staff analysis (continued)

- The VFA was developed to address situations in which the policyholder pays a premium and expects to receive both insurance coverage and investment return in excess of the premium paid. In contrast, in a reinsurance contract:
  - the cedant pays a premium but does not generally expect to receive reimbursements greater than the premium paid. The reinsurer does not provide a cedant with a return on underlying items and keep a proportion for itself as a fee; and
  - the profit the reinsurer earns is not a fee for providing investment management services, it is earned from providing reinsurance coverage
- The Staff thought that the Board did not intend for reinsurance contracts issued to be within the scope of the VFA.

Reinsurance contracts and the scope of the VFA

Staff recommendation, IASB discussion and tentative decision

Staff recommendation

- **The Staff recommended that an entity should not apply the VFA to reinsurance contracts issued or reinsurance contracts held**

IASB discussion

- **There was no discussion about this issue**

Tentative decision

- **The Board unanimously approved the staff recommendation**

Insurance contracts

Next steps

- The Staff expects to:
  - reflect these tentative decisions in a revised draft
  - ask selected parties to provide input on how selected sections of the draft would be applied
  - discuss any further sweep issues that arise from testing and from the drafting process in the 3rd quarter of 2016
  - At that date the staff expect to ask the Board to set a mandatory effective date
- IFRS 4 Phase II could be issued by the end of 2016 and it should become IFRS 17 *Insurance Contracts*

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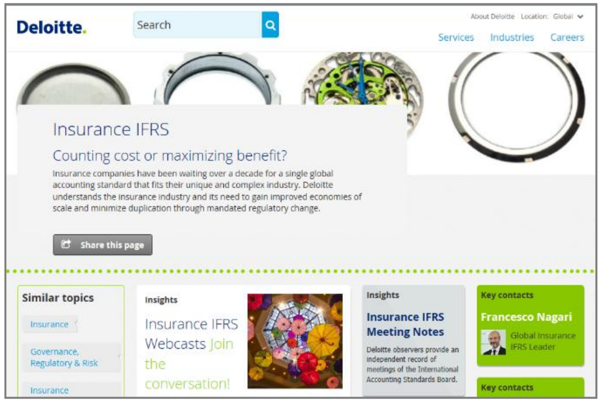

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