

# Insurance Accounting Alert

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## IASB discusses discount rates, reinsurance contracts and level of aggregation

### What you need to know

- ▶ The IASB tentatively decided to confirm the principle for discount rates and provided additional application guidance on how to determine discount rates when there is a lack of observable data.
- ▶ The IASB tentatively decided that subsequent changes in cash flow estimates of reinsurance contracts held should be recognised in profit or loss by the cedant when changes in the expected reinsured losses of the underlying direct contracts are recognised in profit or loss.
- ▶ The Board clarified the objective for the level of aggregation for the future insurance contracts standard and tentatively decided to add guidance that onerous contracts should not be aggregated with profit-making contracts when determining the CSM.
- ▶ In an educational session on the model for participating contracts, the Board tentatively directed the staff to prepare a future discussion on certain topics.

### Overview

During its June 2014 meeting, the International Accounting Standards Board (IASB, or Board) continued re-deliberations on its 2013 exposure draft *Insurance Contracts* (ED). The Board also held decision-making discussions on the following topics:

- ▶ Determining discount rates when there is a lack of observable data
- ▶ Asymmetrical treatment of gains from reinsurance contracts
- ▶ Level of aggregation

The Board also held a discussion on the model for contracts that contain participating features (participating contracts) to give provisional direction to the staff on certain aspects of an alternative model.

### Discount rates

The respondents to the ED generally agreed with the approach to discount rates, but some raised significant concerns on how to estimate discount rates when there is a lack of observable data.

When observable market information is not available, the ED requires entities to use estimation techniques to determine the appropriate discount rate. However, some respondents were concerned that this guidance is not sufficiently clear on how to estimate discount rates for durations for which there are no observable data points.

As the staff felt this lack of clarity could give rise to diverse interpretations, the staff recommended that the Board provides additional application guidance. Specifically, that an entity should use judgement to:

- a) Ensure that appropriate adjustments are made to observable inputs to accommodate any differences between observed transactions and the insurance contracts being measured
- 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



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The staff also provided the Board with suggested wording for implementing this guidance in the future standard. The staff asked the Board to confirm the principle in the ED that the discount rates should be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract.

Some Board members asked for clarification on the practical implications of the fact that any unobservable inputs should not contradict the available and relevant market data. Other Board members queried how the determination of a discount rate would compare to a fair value calculation under IFRS 13 *Fair Value Measurement*. The staff reminded the Board that the measurement objective of the ED is not a fair value estimate, but the guidance in IFRS 13 needs to be considered when determining discount rate used for measuring insurance liabilities. Some Board members added that they would interpret this requirement to mean that the determination of discount rates for insurance contracts should follow the same process that an entity would apply to estimate a Level 3 fair value under IFRS 13. During the meeting, several Board members pointed to the tension that may arise where the observable market data may not have any observable transactions for certain durations, but there are a few longer durations with an observable transaction. The Board members asked the staff to clarify whether any transactions for longer-durations would represent data from an active market and would be required to be used. The staff indicated that judgement would have to be used to determine whether the longer duration transaction was a relevant data point.

### How we see it

Whilst the Board's decision appears to confirm that entities should consider when to place more weight on long-term expectations, tension may arise between the requirement to follow a process that is consistent with IFRS 13 and the possibility to put weight on long-term expectations in certain circumstances. In this context, the final wording of the application guidance on discount rates will be important.

All Board members present at the meeting agreed with the staff recommendation. The staff plans to further develop the wording of the application guidance as part of drafting of the final document.

### Asymmetrical treatment of gains from reinsurance contracts

The staff introduced the topic by reference to concerns raised in some comment letters about asymmetry in the accounting treatment for a cedant's reinsurance contracts and the underlying direct contracts. Specifically, in the ED, a gain on a reinsurance contract is not recognised even if the contractual service margin (CSM) on the underlying direct contracts is nil and changes in estimates of future cash flows are reported in profit or loss.

The staff reminded the Board of its decision at the April 2014 meeting not to revisit the proposed treatment in the ED to include a gain at inception in the CSM and recognised this gain over the life of the reinsurance contract. However, the staff believes the Board should reconsider the treatment after initial recognition to achieve a consistent reporting in subsequent periods. The IASB tentatively decided that subsequent changes in cash flow estimates of reinsurance contracts held should be recognised in profit or loss by the cedant when changes in the expected reinsured losses of the underlying direct contracts are recognised in profit or loss. This would occur when, for example, the underlying direct contracts have become onerous and the CSM on these contracts has been reduced to nil. As a result, it is possible that some of the cash flow changes related to a reinsurance contract are recorded in profit or loss, whilst other changes of that contract are adjusted against CSM.



One Board member queried whether the treatment proposed by the staff would work for the many variations on reinsurance contracts that exist in practice. The staff clarified that, regardless of how the accounting would recognise the reinsurance, the cedant would need to identify direct contracts with a loss, and then look for any reinsurance coverage for these contracts. Because of the foregoing, the staff believes a cedant would have the information available to determine which of the reinsurance cash flow changes should be recorded in profit or loss and which of the changes should unlock the CSM.

After the clarification by the staff, all Board members present supported the recommendation.

### Level of aggregation

#### **Objective and application guidance**

First, the staff discussed the objective and possible application guidance for the level of aggregation. The staff explained that the comment letters to the ED noted that different levels of aggregation could arise and asked that the Board further clarify:

- ▶ Which elements exist within the model that would be subject to a different level of aggregation?

### How we see it

Many respondents that raised concern about the asymmetrical determination of the CSM not only pointed to the subsequent measurement, but also mentioned the initial recognition. As such, the respondents may view the Board's decision as resolving only part of the issue. Once underlying contracts become onerous, the Board's decision will result in a 'frozen' CSM for the reinsurance asset that is released over the remaining contract on the basis of the amount locked in at the point the underlying direct contracts became onerous.

- ▶ Which factors need to be considered in determining the level of aggregation for these respective elements

In order to achieve this, the staff proposes to:

- a) Clarify that the objective of the proposed insurance contracts standard is to provide principles for the measurement of an individual insurance contract, but that, in applying the standard, an entity could aggregate insurance contracts provided that it meets that objective

- (b) Add application guidance to explain that:

- i. In determining the CSM or loss at initial recognition, an entity should not aggregate onerous contracts with profit-making contracts. An entity should consider the facts and

circumstances to determine whether a contract is onerous at initial recognition

- ii. In determining the CSM at subsequent measurement, an entity could combine contracts that have similar release patterns, absolute amounts of the CSM at initial recognition and inception dates and coverage periods

The staff concluded that, if the guidance were changed as suggested, the definition of a portfolio could delete the criterion that risks in the portfolio had to be priced similarly. The staff therefore recommended amending the definition of a portfolio of insurance contracts, as follows: "Insurance contracts that provide coverage for similar risks and are managed together as a single pool".



Several Board members queried how the staff recommendations should be interpreted. One Board member commented that measurement should occur at the portfolio level rather than at the individual contract level to reflect the law of large numbers that is fundamental to insurance. However, the Board member felt this was not clear in the staff proposals. The staff responded that, when considering the expected cash flows per policy as an average for all contracts that are part of a portfolio, on a conceptual level, it should not matter whether an entity looks at the individual or portfolio level. However, the staff added that entities may apply different pricing relative to the risk to similar contracts. In the staff's view, this differentiation in pricing should be taken into account when grouping contracts for the purpose of determining the CSM to avoid (groups of) loss-making contracts that are masked by commingling them with (groups of) profitable contracts.

Several Board members indicated that, irrespective of whether cash flow estimates are determined at the portfolio or the individual contract level, the portfolio level should simply be an easier way of implementing a contract-by-contract approach. However, many Board members

expressed concern that the specific guidance in (b)ii above represent rules that are too restrictive. Instead, these Board members would prefer to use this guidance to provide examples on how an entity could aggregate contracts but, at the same time, satisfy the objective for determining the CSM at a subsequent measurement. The staff agreed with this suggestion and asked the Board to vote on the recommendation as amended for this suggestion. Of the Board members present at the meeting, fourteen IASB members agreed and one disagreed.

#### **Accounting policy for presenting effects of changes in discount rates**

The staff also asked the Board to further clarify the level of aggregation for applying the accounting policy choice on where to recognise the effects of changes in discount rates. At its March 2014 meeting, the Board tentatively decided that an entity should choose to present the effect of changes in discount rates in profit and loss or in other comprehensive income as its accounting policy. The Board required that an entity should apply that accounting policy to all contracts within a portfolio.

The staff believes IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* offers sufficient rigour to prevent entities from creating new portfolios with the sole aim of applying different policies to similar contracts. The staff therefore recommended that the Board clarifies that, in accordance with IAS 8, an entity should select and apply its accounting policies consistently for similar contracts, bearing in mind, the portfolio in which the contract is included, the assets that the entity holds and how those assets are accounted for. Staff noted that the Board will discuss the guidance for when a change in accounting policy would be justified at a future meeting.

Ten Board members agreed with this decision and five Board members disagreed, (one board member was absent).

#### **How we see it**

The Board decision means that the definition of a portfolio will be the same as the existing definition in IFRS 4 *Insurance Contracts*. However, the addition of the guidance that an entity should not aggregate onerous contracts with profit-making contracts may result in many preparers perceiving the level of aggregation under the future standard as being more granular compared with their current portfolios and questioning whether the level of aggregation allows for pooling of individual risks at an appropriate level. The examples requested by the Board on how to apply the principle for the level of aggregation will be fundamental to understanding the Board's intentions.



### **Participating contracts (educational session)**

The staff reminded the Board of the initial education session held on participating contracts in May.<sup>1</sup> The staff explained the purpose of the discussion during the June meeting was also educational, but with the aim of obtaining the Board's direction on how to limit the application of alternative adaptations that it might make to its general building block model for insurance contracts. The staff emphasised that any direction given by the Board should be regarded as preliminary and would depend on whether the Board decides in future meetings to pursue certain changes.

One of the key points for adaptation identified during the May educational session was whether an entity should adjust the CSM for changes in its share of the underlying items. The staff plans to ask the Board to consider whether an entity should adjust the CSM for changes in the insurer's share of the underlying items on the grounds that the insurer's share represents an implicit management fee. The staff added that the Board should consider that question under the assumption that an implicit asset management fee exists only when:

- i. The returns to be passed 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)

- ii. There is a minimum amount (either fixed or determinable) that the entity must retain
- iii. The policyholder will receive a substantial share of the total return on underlying items

During the discussion, Board members expressed differing perspectives and preferences on whether and how an entity should adjust the CSM for changes in the insurer's share of the underlying items, but all understood this is an important topic that needs to be addressed. Accordingly, the Board tentatively directed the staff to prepare a future discussion on the topic on the basis of a staff proposal.

Another important aspect of an accounting model for participating contracts identified during the May educational session is the determination of the interest expense in profit or loss. Some comment letters suggested applying a 'book-yield' method for determining the interest expense in profit or loss. Under this method, the rate (book yield) for calculating the interest expense is derived from how the underlying items supporting the contracts are reported in profit or loss. The staff explained this is only relevant to presentation in the statement of comprehensive income and does not affect the measurement of the insurance contracts in the statement of financial position. The staff plans to ask the Board to consider whether an entity should apply a book yield approach for determining the interest expense presented in profit or loss only for contracts in which:

- i. The returns passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items)
- ii. The policyholder will receive a substantial share of the total return on underlying items

Some Board members were sympathetic to the idea of applying a book yield as it would resolve the accounting mismatches for profit or loss by accommodating the mixed measurement model in IFRS 9 *Financial Instruments*. However, several Board members raised questions about the practical application of the book yield method and expressed concerns about potential complexity. The Board tentatively directed the staff to prepare a future discussion on the topic on the basis of the staff proposal, but also asked the staff to explore further the mechanics of the book yield approach to help it understand the complexities of that approach.

The Board plans to make decisions about the accounting for contracts with participating features as a whole at a future meeting. This discussion will also include:

- ▶ Whether an entity should adjust the contractual service margin for the insurer's share of the underlying items
- ▶ Which approach to use for determining the interest expense presented in profit or loss

<sup>1</sup> See *Insurance Accounting Alert*, May 2014, IASB makes use of OCI optional and confirms unlocking of the Contractual Service Margin

## How we see it

From the discussions at the June meeting, it is clear that Board members still have differing views on the various aspects of an adaptation of the general model to participating contracts. The Board provided the staff with some direction on how to prepare for forthcoming decision-making sessions on this area, taking into account some of the suggestions made in the comment letters. However, the Board clearly is still hesitant to adopt some of these suggestions. Nevertheless, by instructing the staff to go ahead and further evaluate an alternative to the mirroring proposal in the ED seems to indicate that the Board acknowledges that some form of adaptation of the general building block model to participating contracts will be inevitable.

## What's next?

The Board's next meeting on the insurance contracts project is in July; the topics have not yet been announced. The IASB expects to complete re-deliberations on its insurance contracts proposals in 2014, with the publication of a final standard in 2015.



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