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IFRS Developments

Insurance Accounting Alert

Boards discuss onerous contract testing and measurement of options and guarantees

What you need to know

- The Boards agreed on the definition of a test for onerous contracts
- They decided that the measurement of options and guarantees in certain participating contracts should be measured using a current market consistent expected value approach
- They also reaffirmed their decisions to require discounting of claims liabilities when the effects of discounting would be material, and decided to provide a practical expedient that would permit insurers not to discount certain incurred claims
- The IASB decided not to specify further guidance on the unit of account for the risk adjustment
- The IASB also agreed to consider the use of OCI for some debt instruments recorded at fair value as a potential limited improvement to IFRS 9

Overview

On December 15 and 16, the International Accounting Standards Board (the IASB) and the Financial Accounting Standards Board (the IASB and the FASB, respectively, or, collectively, the Boards) held joint meetings to continue their re-deliberations of the tentative decisions in the IASB's Exposure Draft *Insurance Contracts* (ED) and in the FASB's Discussion Paper *Preliminary Views on Insurance Contracts* (DP). A large part of the meeting was devoted to discussing the definition of portfolio grouping of cash flows for determining the residual/ single margin, and the risk adjustment (IASB only). The remainder of the meeting covered:

- Onerous contract testing
- Measuring options and guarantees in participating contracts
- Participating dividends that may be paid out to future policyholders

And

- Discounting of liabilities for incurred claims

Unit of account (portfolio)

A key objective for the Boards is to develop a definition for a portfolio that could be applied uniformly across the application of the standard. This definition has perhaps its most fundamental importance to the groupings for determination of cash flows when the building block method is applied. Use of a portfolio is seen as consistent, with the idea that assumption of risk and pricing are done on the basis of pooling many individual insurance contracts into groups of contracts.

The Boards discussed a staff proposal that the definition of a portfolio should be a group of insurance contracts that are subject to similar risks, that have similar expectations of profitability, and that are managed together as a single pool. While various Board members saw merit in the attributes, they did not agree to accept the staff's proposal. Several board members had differing views on the appropriateness of including a profitability factor. Some Board members noted that the groupings of contracts should not be allowed to conceal unprofitable contracts by combining them with profitable contracts for determining margins, while other members noted that insurance is based on the pooling of risks; reporting losses that are followed by higher profits may not reflect the economics of the portfolio. Several Board members commented on the relevance of profitability to the run-off pattern of margins (either residual or single margins). The Boards, therefore, asked the staff to develop a revised proposal for the definition of the portfolio based on a notion of contracts with similar durations and expected patterns of margin release.

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The Boards acknowledged that the standard should give guidance on the unit of account because there may be instances where grouping may need to differ from portfolios for specific reasons. The Boards noted, for example, that the determination of the initial residual/single margin will have to consider contracts with similar effective dates, which grouping is likely to be a subset of a portfolio (i.e., a sub-portfolio). The Boards also agreed that the allocation of the margin to accounting periods is to be made for sub-portfolios that reflect inception dates, expected end dates and expected patterns of release of the residual/single margins. Use of cohorts is a practical necessity, in the Boards' view, as use of portfolios likely would not properly reflect the relative terms of contracts and could lead to inappropriate allocations of the margins.

The IASB tentatively decided not to prescribe the unit account for setting the risk adjustment, and instead reiterated that the risk adjustments should be determined in a manner that achieves the overall objective (i.e., the compensation the insurer requires for bearing the risk that the ultimate cash flows will exceed those expected). A majority of the IASB members believed that considering when and how to incorporate the effects of diversification of risks into the measurement was implicit in the statement of the objective for the risk adjustment. The IASB staff noted that, regardless of how the principle for the risk adjustment is expressed, application guidance to support that principle is necessary.

How we see it

The IASB's decision not to prescribe a grouping for the determination of a risk margin seems to imply that, based on the stated objective, insurers may be able to consider cross-portfolio effects and use pricing practices as an input to such consideration. If insurers consider diversification benefits differently in light of the compensation they require for bearing risk, disclosure of policies would be needed to allow for comparison.

Onerous contracts

The Boards decided that an onerous contracts test should be applied to contracts accounted for under the premium allocation approach. They agreed that these contracts are onerous if the expected present value of the future cash outflows (and the risk adjustment for the IASB) exceeds the carrying amount of the liability for remaining coverage. The Boards also decided that an insurer should perform an onerous contract test when facts and circumstances indicate that contracts could be onerous, and agreed to provide guidance about those facts and circumstances.

As a result of their previous decision to recognise contracts at the start of the coverage period, the Boards concluded that an onerous contracts test would be necessary to identify and recognise losses from onerous contracts during the pre-coverage period (i.e., the period until the start of the coverage period stated in a contract). The Boards agreed that onerous contracts identified in the pre-coverage period should also be measured on the basis of expected present value of the future cash outflows (and the risk adjustment for the IASB).

The Boards discussed various specific topics related to onerous contracts, but deferred decision making until a future meeting, for example whether the measurement for the onerous contract should be updated.

How we see it

The exact impact of applying the onerous test is uncertain, as the Boards did not decide on the aggregation level for performing the test. Although including a risk adjustment in the measurement of onerous contracts (IASB only) would make the measurement consistent with the measurement of incurred claims, it creates the possibility that some contracts could be onerous for accounting purposes when they are cash neutral (i.e., present value of the expected cash inflows exceed present value of the expected cash outflows).

Participating contracts

The FASB updated the IASB on its recent decisions regarding participating contracts for which the liability is linked to specific assets. While the previous decision by the IASB and the recent decision by the FASB had the same objective to eliminate accounting mismatches created by timing differences, the words used to describe the respective decisions are different. The Boards asked the staff to search for a common set of words for their approach to participating contracts.

The discussion on options and guarantees contained in participating contracts addressed those that are not required to be separated under the guidance for embedded derivatives (and separately accounted for under the financial instruments guidance). The proposed requirements for options and guarantees are intended to ensure that the options and guarantees are appropriately reflected in the insurance liability. Since measurement of participating contracts should reflect the measurement of the underlying items, the Boards decided to clarify that the measurement of options and guarantees that are not separated as embedded derivatives should be measured using a current, market-consistent, expected-value approach.

The Boards have also decided that insurers' obligations to future policyholders arising from cash flows of participating contracts should be recognised as liabilities. In the view of the Boards, this treatment would reflect the fact that amounts must eventually be paid to policyholders.

How we see it

The Boards are concerned that options and guarantees may not be appropriately recognised and measured for some participating contracts when the insurance liability value is set equal to the net value of the linked items. The proposed method to measure the participating contracts with options and guarantees may raise questions in the market place about how to apply a market-consistent approach to options and guarantees within the concept of a fulfilment value that is the stated objective of the building blocks approach. For example, the reference to a market-consistent measurement may lead actuaries to conclude that the range of scenarios underlying the expected value must be based on risk-neutral rather than realistic assumptions, and in that regard may be viewed as different from the concept of a fulfilment value.

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Discounting incurred claims

The Boards tentatively confirmed that the discounting of incurred claims is not necessary when the effects of discounting are immaterial (for contracts using the premium allocation approach). They do not intend to provide guidance on how to determine when the effects of discounting are not material. The Boards also decided that there would be a practical expedient allowing insurers to not discount portfolios where incurred claims are expected to be paid within 12 months of the insured event, unless facts and circumstances indicate payments will no longer occur within 12 months.

How we see it

As in other projects, the Boards view materiality as a generic concept and have avoided giving guidance on materiality related to specific situations. It is important to note that the Boards do not intend to apply the exemption to coverage types within a contract, but to entire contracts. Therefore, contracts that contain both short-tail and long-tail exposures (e.g., motor insurance) are not necessarily exempt. The conclusion that those contracts do not need to be discounted still rests on considerations of materiality.

Limited changes to IFRS 9

During its November meeting, the IASB made the unanimous decision to start a debate on IFRS 9 *Financial Instruments* by considering limited changes to the classification and measurement requirements of that standard. The IASB noted that a key reason to look at IFRS 9 classification and measurement is the need to consider the relationship with the developments in its insurance project, specifically on the topic of OCI.

At its December meeting, the Board identified the following areas for potential improvements to IFRS 9:

- Use of OCI for some debt instruments recorded at fair value
- Characteristics of financial assets test
- Bifurcation of embedded derivatives within financial assets

The IASB noted that, during the debate on the above topics, consideration will be given to possibilities for aligning the IFRS 9 model with the FASB's proposed financial instruments model.

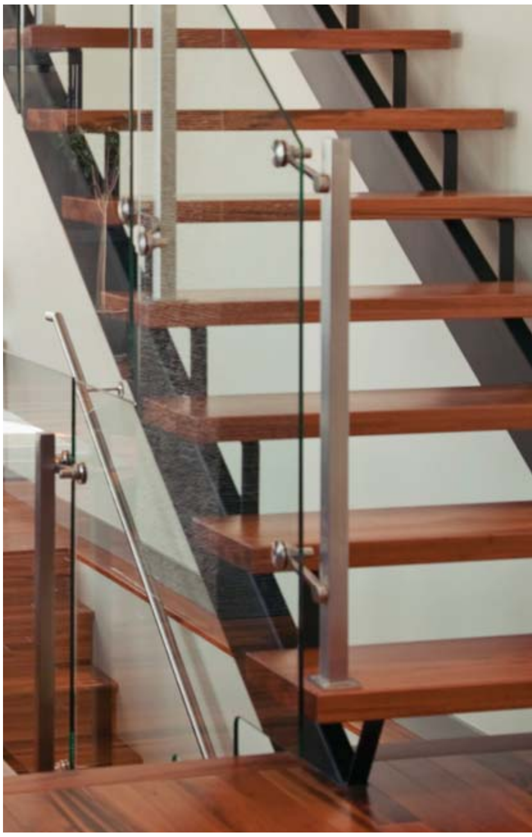
How we see it

The IASB's plan to look at OCI for assets under IFRS 9 may indicate that it intends to first decide on whether to expand the use of OCI for assets before starting to look at an OCI solution within its insurance contracts project. This could reflect a desire to consider an OCI approach for assets from a broader IFRS 9 perspective, rather than to look for an industry-specific approach.

Next steps

The IASB plans to issue a revised exposure draft or a review draft of the final standard in the first half of 2012. It will establish a publication date for the final standard in due course. The FASB currently aims to issue its exposure draft in the same period.

The Boards will have their next discussion on insurance during the January Board meetings; the topics have not been announced.



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