Agenda Paper 10.2 Notes from Roundtable on ED244 (ED/2013/7) *Insurance Contracts*

Sydney – 3 September 2013
Melbourne/Auckland – 12 September 2013

Sydney Roundtable

Participants via videoconference from London:

Stephen Cooper, Gary Kaburek and Patrick Finnegan (IASB members), Andrea Pryde, Joanna Yeoh and Barbara Jaworek (IASB staff).

Participants in Sydney:

Ian Mackintosh (IASB member), Allana Kelly (Suncorp), Andrew Kitchen (IAG), Anne Driver (QBE), Brendan Counsell (EY), Craig Whittaker (TAL), David Jewell (EY), David Rush (APRA), Graham Duff (AMP), Grant Robinson (Actuaries Institute), Joan Cleary (QBE), Scott Hadfield (PwC), Tony Coleman (AMP Life), Tony Rose (Lachlan Partners), Warren McGregor (PwC), Angus Thomson and Sue Lightfoot (AASB staff).

Participants via videoconference from Melbourne:

Kevin Stevenson and Victor Clarke (AASB members).

Melbourne/Auckland Roundtable

Participants in Melbourne:

Alastair Higham (Department of Finance and Deregulation), Kevin Roberts (CGU), Richard Land (Actuaries Institute), Vincent Sheehan (Ernst and Young), Warren McGregor (Financial reporting consultant), Carmen Ridley and Kevin Stevenson (AASB members), Angus Thomson and Sue Lightfoot (AASB staff).

Participants in Auckland:

Catherine Johnston (PwC), Mark Hucklesby (Grant Thornton), David Pacey (Ernst and Young), Elaine Hultzer (KPMG), Michael Bartram (ANZ), Thomas Brown (ACC), Sean Kam (Partners Life), Ignacio Rotaeche (Lumley General Insurance), Kimberley Crook (NZASB member), Karl Hickey (NZASB member), Clive Brodie (NZASB staff).

There were also a number of observers in attendance at each Roundtable.

At the Sydney Roundtable Ian Mackintosh provided a brief presentation on the key features of ED/2013/7 *Insurance Contracts*.

The issues paper provided to participants is attached as an Appendix to this Agenda Paper. That issues paper gave background to the issues discussed at the roundtable. (Due to time constraints only issues 1 to 4 were discussed at the Sydney Roundtable).

1 Contractual service margin (CSM)

A number of constituents supported unlocking the CSM as a similar approach has worked well under the Margin on Services (MoS) approach in Australia by life insurers. A smaller number preferred 'locking' the CSM and amortising it over a specified period, taking the view that the CSM is effectively a balancing figure to avoid recognition of day-one gains. Some sought more clarity over the unit of account for the CSM.

Some did not support the change in risk margin being taken to P/L in full, but considered that the change relating to past and future coverage could be determined. In their view the portion of the change relating to past coverage should be taken to P/L and the portion of the change related to future coverage should be included (adjusted) in the margin to be recognised in P/L in future periods – the reasons given in paragraph BC37 were not considered to be persuasive.

IASB staff indicated that the risk margin remeasurement to P/L was proposed as a simplification over concerns that allocation between past and future coverage portions could be overly complex and to avoid subjectivity. Some constituents indicated that it was straight forward and already performed for general insurance by class of business, although it would be new for life insurance. It was also noted that the split formed part of the APRA quarterly reporting for general insurers and is audited.

It was identified by some that it would be useful to have guidance on whether loss reversal and 'rebuilding' of the CSM is possible (the draft seems to be silent on this).

A participant commented that paragraph 31 of ED/2013/7 seems to provide an unnecessary catch-all by saying that whatever is not considered to affect CSM must be recognised in profit or loss. What may or may not affect CSM is not clear and this requirement could therefore be open to interpretation. This could also lead to inconsistency or manipulation.

2 'Mirroring'

A number of constituents commented that, on the face of it, mirroring seemed like a good idea. However there were significant concerns raised around how mirroring would be applied to certain products. For example, it seemed it could work relatively simply for unit-linked products, but for participating contracts that also involve sharing returns from risk business between shareholders and policyholders it could prove complex. The examples provided were considered to be relatively simple and they do not cover application of more complex products, such as those that include embedded derivatives, surrender options and guarantees.

It was noted that, where the investments to which policy liabilities are linked are assets of other entities in a group, mirroring might be applicable in separate financial statements but if the relevant assets would be eliminated for group financial statements, the mirroring would need to be eliminated. Whilst acknowledging that this was not a situation unique to the insurance contracts project it was identified as an additional complexity.

One constituent commented that mirroring would result in accounting that was not in alignment with the Life Act so it would drive a difference between accounting and regulatory reporting. A view was also expressed that alignment with local regulatory reporting could be a preferable approach.

3 Revenue and expenses recognition and presentation

Some constituents considered that the proposed approach is superior to the summarised margin approach of the IASB's 2010 ED. There was some concern about the complexity of the approach for long term contracts which have both investment and insurance components (where unbundling is not performed). IASB members commented that the calculated revenue amount was integrated with the calculation of the liability.

There was support for having one measurement model with both the building block approach (BBA) and premium allocation approach (PAA) being applicable based on the circumstances. Some noted that this could reduce compliance costs for entities that issue both life and general insurance contracts as it would generally enable the same approach to be applied across the entity.

Reporting revenue when ‘earned’, consistent with reporting of other non-insurance revenue, would facilitate reporting of more compact statements of comprehensive income and so avoid unnecessary over-emphasis of insurance revenue in the case of large groups that have revenue from many other types of business (not just insurance business).

However, concern was raised over presentation in the case where investment and insurance components could not be unbundled.

It was noted that the presentation did not include gross unearned premium, which is a globally recognised metric of significance to users. Some also had concerns that existing comparability globally between general insurers would be lost by trying to require life and general contracts to comply with a consistent approach.

It was noted that, although the approach of recognising revenue when earned is preferred to recognition of revenue when received, this would require a change in mind-set for users of life insurers’ financial statements who are accustomed to revenue being premium received during the current period. It was also noted that it may be difficult to explain profit from lapsed contracts, however, these sorts of difficulties are dealt with in other industries.

It was also noted that there was not full disclosure for the simplified approach. As a result there could be undue prominence given to the liabilities measured using the BBA even if they are a more minor part of an entity’s insurance liabilities overall.

4 Use of other comprehensive income (OCI)

It was noted that, in Australia, insurance liabilities had been discounted since 1991 and that actuaries currently analyse the change in result due to inflation and interest. However, one participant was of the view was that the IASB should clarify the appropriate discount rates to use.

There were concerns that the IASB seemed to be assuming a particular business model for an insurer involving assets and liabilities viewed on an historical cost basis being matched. It was noted that it is difficult to form a view on how well the accounting might reflect the economics of the way in which insurers manage asset and liability mismatch risk without knowing where IFRS 9 will land (including availability of a fair value option and, if available, under what criteria).

It was also noted that there was no guidance on how the ‘cohorts’ should be identified for determining which discount rate to use as the rate at inception. One participant suggested that needing to apply the proposals for OCI could result in it being similar to applying IFRS transition mark II. The cost would be potentially significant depending on the level of cohort to which the requirements applied. Operational risk was also noted as potentially being problematic in terms of accurately measuring the OCI amount.

One participant said it was difficult to understand the approach on a conceptual basis given that the proposed approach is a current value model with just the one historical cost element. A constituent from a life insurer commented that there have been attempts to provide an indicator of the profit that management is accountable for but this proposal did not align with those attempts. Some insurers are separately presenting the current period change in discount rate impact on a current value basis in analyst briefings (rather than tracking of changes from contract inception).

It was noted that a consistent basis for determining items that are presented in OCI has yet to be developed.

It was raised that factors other than interest rate movements also affect the result and would need to be analysed to explain the result. It was questioned whether the proposed OCI approach on a cost-benefits basis was justified given the likely costs of implementation on an ongoing basis.

It was questioned whether there could be a different business model in the approach, and some participants considered that there were different business models within life insurance as well as between life and general insurers. For some, the OCI approach could be suitable – but that approach should not be forced on all insurers. Some of the business model difference may be between those insurers that focus on risk business versus those that focus on savings and accumulation business.

Some participants sought clarity about the required unit of account – whether at contract or portfolio level.

Some thought alternative approaches could be used to provide useful information on profit drivers e.g. disclosures. Support was expressed for Stephen Cooper's dissenting view to ED/2013/7. There was much scepticism about whether the OCI approach would provide useful information on 'duration mismatch' which was suggested by the IASB as one rationale for using OCI. A comment was made by one participant that credit spreads have an impact on the result, as do mismatch of assets and liabilities and that there would be much more useful and less costly ways of presenting that information. A concern was raised by the same participant that selective disposal of assets and the recycling of amounts to P/L on their disposal (as proposed in the IASB's IFRS 9 ED for debt instruments at FVOCI) would provide a 'lever' to generate P/L and could therefore be used to 'manage earnings'.

A number of participants supported the notion of not requiring the use OCI and instead providing the OCI approach as an option for those that might want to use it, perhaps on a conditional basis. Some guidance should be provided around how any option could be made workable – one participant suggested it should be on a whole-of-entity basis and should not be on a measurement mismatch basis.

IASB staff indicated that similar concerns had been raised by other jurisdictions including the UK and South Africa.

A request was made by a participant for the same effective date for IFRS 9 and the insurance standard.

One participant welcomed the proposal to recognise changes in discount rate in OCI so that profit or loss appropriately focusses users on underlying profit on the grounds that currently small changes in discount rate cause significant volatility in profit and loss.

A number of participants had the view that the proposed split is overly complex to apply, particularly when combined with related impairment and hedge accounting requirements.

5 Transition

There was strong support for the revised proposals. Many noted that they are preferable to the proposals in ED/2010/8 which most considered were clearly inappropriate (i.e. that no profit be recognised on contracts written prior to adoption of the standard).

Despite this view, some considered it likely that many entities will not be able to (or will claim to be unable to) find sufficient information to apply the proposals retrospectively; particularly once they need to look more than a few years into the past. Also, use of old information creates a challenge for auditing. Some considered that it would be particularly difficult to determine transition amounts for participating contacts.

6 Premium allocation approach

Some participants noted that many life insurers may have contracts that fall within the 12-month period such that they are automatically entitled to use the premium allocation approach (PAA) for those contracts. However there was concern that permitting the PAA to be used as a choice for those contracts would provide an opportunity for arbitrage in selecting which approach to apply. There was concern that for contracts with coverage periods greater than 12 months, having to demonstrate that the PAA approximates the building block approach (BBA) is too onerous (ie. if an entity would have to determine the accounting for the building block approach to demonstrate that they do not have to apply the BBA).

Some were of the view that it would be preferable to have no bright-line 12-month cut off; an entity should be able to apply the PAA whenever it achieves a result close enough to the building block approach. The coverage term of the contract could be used rather as an indicator that the PAA would approximate the building block approach and, therefore, that the PAA may be appropriate.

7 Unbundling

Some participants considered that the proposals may force more contracts to be combined for accounting ('bundled'), but thought that this would be appropriate if cash flows were 'highly interrelated' (paragraph B31). Some from the actuarial profession thought they would probably prefer more unbundling of contracts.

Some considered that the principle of bundling/unbundling being based on whether or not there is high interrelatedness of cash flows is appropriate. However, the addition of rules and exceptions to that principle (such as the proposed rule that a co-terminus lapse date for components of a contract prevents unbundling) may not be helpful in achieving accounting that aligns with that overriding principle. Others raised the prospect that some of the unbundling concerns might be dealt with via the proposals on separating components of contracts – that is, some contracts that are currently unbundled under Australian GAAP might be treated as two or more contracts under the proposals.

Some were concerned that there may be a disconnect between the principles and rules for bundling and unbundling and the requirements of IAS 8 *Segment Reporting*. It appears that an entity may have to bundle or unbundle contracts for accounting under the insurance standard only to reverse this for segment reporting.

8 Contract boundary

This was not specifically discussed.

9 Disclosure

Some participants considered that ED/2013/7 proposes too much disclosure. There were concerns that the IASB has an increasing tendency towards requiring reconciliations that lack an underlying basis.

Some were concerned that the disclosures were excessive and seemed to be trying to provide information beyond the scope of the common needs of general purpose financial statement users for decision-making.

APPENDIX
AASB and NZASB Roundtable Issues Paper
Insurance Contracts

Purpose of this paper

The purpose of this paper is to identify issues for discussion at the roundtables on IASB ED/2013/7 *Insurance Contracts* in Sydney (3 September) and Melbourne-Auckland (12 September). The main focus is on the specific issues raised by the IASB in ED/2013/7. In considering the issues, participants are encouraged to identify the benefits and costs associated with the particular proposals and, where relevant, alternative approaches that they consider to be superior to the particular proposals.

Key issues for consideration

An overview of the IASB's proposed Insurance Contracts model is provided in the Appendix to this paper.

1 Contractual service margin (paragraphs 30-31, B68, BC26-BC41 and IE9-IE11)

1.1 In ED/2013/7, the IASB proposes that insurance liabilities include a contractual service margin (known as the 'residual margin' in IASB ED/2010/8 *Insurance Contracts*) that is remeasured ('unlocked') with differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services being added to, or deducted from, the contractual service margin, so long as the margin does not become negative. Any change in estimates of cash flows not related to future services/future coverage is recognised in profit or loss immediately.

1.2 Do you agree with the proposal to recognise changes in estimates of cash flows in this way?

2 'Mirroring' (paragraphs 33-34, 66, B83-B87and IE23-IE25)

2.1 ED/2013/7 includes, as an exception to the normal requirements, a proposal that insurance liabilities in respect of contracts that: i) require the insurer to hold underlying items; and ii) specify a link to policyholder returns on those underlying items; would be measured by reference to the carrying amount of the underlying items ('mirroring contracts') for the cash flows that vary directly with the underlying items. Components of insurance liabilities for the cash flows that are not expected to vary directly with returns on underlying items would be measured using the normal requirements.

2.2 Changes in fulfilment cash flows would be recognised as below:

Cash flows	Recognition
• those expected to vary directly with returns on the underlying items	• recognised in PL or OCI on the same basis as the recognition of changes in the value of the underlying items
• those expected to vary indirectly with the returns on the underlying items	• recognised in PL
• those that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits)	• recognise in PL and in OCI in accordance with the 'normal' requirements

2.3 Do you support the proposed measurement and presentation exception for 'mirroring contracts'?

2.4 It is proposed that the 'exception' is mandatory. Would you support it being made available as an accounting policy choice?

3 Revenue and expense recognition and presentation (paragraphs 56-59, B88-B91, BC73-BC116 and IE12-IE18)

3.1 The IASB's proposals in ED/2013/7 would require allocation of premiums between the amount that relates to the risks already borne (ie. premiums already 'earned') and the amount that relates to bearing of risk in the future (ie. 'unearned' premiums). Under AASB 1023 *General Insurance Contracts* and NZ IFRS 4 *Insurance Contracts* Appendix D the revenue recognised and presented relates to the risks already borne. Insurance contracts currently recognised under AASB 1023 and NZ IFRS 4 Appendix D are likely to be eligible for accounting under the premium allocation approach or 'PAA' proposed by the IASB in ED/2013/7 which is akin to the current AASB 1023 and NZ IFRS 4 Appendix D accounting treatment. However, under AASB 1038 *Life Insurance Contracts* and NZ IFRS 4 Appendix C premiums are recognised as revenue on receipt and so the proposals would be a change that would require an allocation of premiums to determine the revenue for each reporting period.

3.2 Do you agree with the proposals in terms of the recognition of revenue and expenses arising from insurance contracts that should be presented in the income statements?

3.3 Do you prefer the proposed presentation to the 'summarised margin' approach, proposed in IASB ED/2010/8) which would have required presentation of changes of components of insurance liabilities?

4 Use of other comprehensive income (OCI) (paragraphs 60-68 and BC117-BC159)

4.1 ED/2013/7 proposes that the change in the carrying amount of an insurance contract liability due to the difference in the discount rate at reporting date and the discount rate at initial recognition of the contract be required to be presented in OCI.

4.2 Do you have issues to raise about the proposed presentation in OCI of the 'difference' due to discount rate changes – and, if so, what is the nature and impact of those issues?

4.3 Would you support OCI presentation being made available as an accounting policy choice – and, if so, how should the choice be made available (eg. whole entity, portfolio, sub-portfolio)?

Other issues for consideration

5 Transition (paragraphs C1-C13, BC160-BC191 and IE26-IE29)

5.1 In ED/2013/7, the IASB proposes that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (AASB 108 and NZ IAS 8 of the same name) would apply on transition and therefore would require retrospective application of the proposed requirements when practicable. Where retrospective application is not practicable a simplified approach would be used, maximising the use of objective data.

5.2 Do you have insurance contracts for which retrospective application would not be practicable?

5.3 What lead time would you require to implement the proposed requirements if they were to proceed as set out in ED/2013/7?

6 Premium allocation approach (paragraphs 35-40)

6.1 Do you agree with the proposal to permit the premium-allocation approach to measuring pre-claims insurance liabilities if it reasonably approximates the 'normal' requirements (the 'building block approach'), or where the coverage period is one year or less?

7 Unbundling (paragraphs 9-11 and B31-B35)

7.1 In ED/2013/7, the IASB proposes to require separate accounting ('unbundling') of investment contract components, when the investment component is 'distinct' and not 'highly interrelated' with the insurance contract component. An investment component is distinct if a contract with equivalent terms is or could be sold separately in the same market. The investment and insurance components are highly interrelated if they cannot be separately measured, or the benefit from one component depends on the other – if the lapse/maturity causes the lapse/maturity of the other, the components are not separately accounted for.

7.2 Do you have issues to raise about the requirement to unbundle an investment component from a host insurance contract if it is 'distinct' and not 'highly interrelated'?

8 Contract boundary (paragraphs 22-24 and B62-B67)

8.1 The ‘fulfilment cash flows’ of an insurance contract are proposed to be those within the boundary of the insurance contract, which is described as being when the entity can compel the policy holder to pay the premiums or, when a substantive obligation to provide coverage/other service ends. A substantive obligation would end when the entity has the right or practical ability to reassess the risks and set a price or level of benefits that reflects those risks, or the reassessment can be done for the portfolio that contains the contract and pricing does not take into account future periods.

8.2 Do you expect that this approach will result in any changes from the current requirements– and, if so, what is the nature and impact of those changes?

9 Disclosure (paragraphs 69-95)

9.1 ED/2013/7 sets out the IASB’s proposed disclosure requirements in relation to insurance contracts.

9.2 Do you consider that the requirements are appropriate? Would the level of additional disclosure and information provided justify the additional cost?

10 Other issues

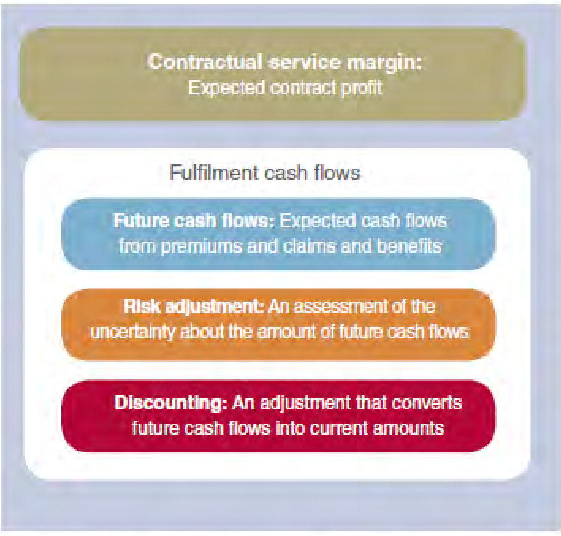
10.1 Do you have any other issues that you would like to raise? For example, issues relating to the proposed:

a. scope of the revised IFRS 4 *Insurance Contracts* (paragraphs 3-7);
b. discounting requirements (paragraphs 25-26 and B69-B75);
c. reinsurance requirements (paragraphs 41-42); or
d. requirements relating to investment contracts with discretionary participation features (paragraph 47-48)?

APPENDIX TO THE ISSUES PAPER

Overview of the IASB proposed Insurance Contracts Model[1]

Balance Sheet



The balance sheet amount reflects the expected contract profit from the insurance contract and a current estimate of the amount of future cash flows from the insurance contract, adjusted to reflect the timing and uncertainty relating to those cash flows.

Statement of Comprehensive Income

	20XX
Insurance contracts revenue	x
Incurred claims and expenses	(x)
Operating result	x
Investment income	x
Interest expense on insurance liability	(x)
Investment result	x
Profit or loss	**x**
Effect of discount rate changes	(x)
Total comprehensive income	**xx**

The statement of comprehensive income reports an operating result which reflects underwriting experience, the change in uncertainty and the profit from services in the period and, through the interest and discount rate changes, both a current and a cost-based view of the cost of financing the insurance contract.

[1] IASB Snapshot on its Exposure Draft ED/2013/7 *Insurance Contracts*, page 5.