

**Staff analysis and preliminary views on the proposals in the IASB's  
Exposure Draft ED/2010/8 *Insurance Contracts***

## Background

1. The purpose of this Agenda paper is to assist the AASB and FRSB in identifying issues to be included in the AASB's submission to the IASB on ED/2010/8 *Insurance Contracts*. Staff anticipate that any issues the AASB and FRSB decide should be included in a submission to the IASB based on this Agenda paper will be subject to the outcomes from the roundtable discussions and other discussions with constituents prior to the submission being finalised. It is not anticipated that the AASB or FRSB will formally meet again prior to the due date for submissions on ED/2010/3. Accordingly, the AASB's submission to the IASB on ED/2010/8 will be finalised out-of-session.
2. For each of the IASB's questions in ED/2010/8, this Agenda paper provides:
  - (a) a high-level summary of the relevant proposals;
  - (b) an analysis of the proposals; and
  - (c) staffs' preliminary views on the proposals.
3. This Agenda paper also incorporates issues raised in the written responses received on the AASB's ED 201 *Insurance Contracts* (which incorporates ED/2010/8) (see Agenda paper B8.4 to this meeting).
4. As discussed at the AASB's and FRSB's respective September 2010 meetings, there are many similarities between the ED/2010/8 proposals and existing AGAAP/NZGAAP. For the purpose of this Agenda paper, however, staff have attempted to assess the proposals in ED/2010/8 on their individual merits rather than whether they accord with our existing GAAP. Nevertheless, as some AASB and FRSB members are likely to be interested in the similarities and differences between AGAAP/NZGAAP for insurance contracts and the proposals in ED/2010/8, Agenda paper B8.3 to this meeting provides a high level comparison of AGAAP and the IASB's proposals. (**Please Note:** Agenda paper B8.3 to this meeting is largely the same as Agenda paper B5.2 to the FRSB's August meeting and Agenda paper 15.2 to the AASB's September 2010 meeting.)
5. While the AASB has not yet deliberated on the proposals in ED/2010/8, the FRSB has made some tentative decisions regarding these proposals. Appendix A to this Agenda paper provides a copy of the draft minutes of the FRSB's meeting held on 26 August 2010, which includes the FRSB's tentative decisions to date on the proposals in ED/2010/8.

## IASB questions on the proposals in ED/2010/8 and staff's preliminary views

### **Question 1 – Relevant information for users (paragraphs BC13–BC50 of ED/2010/8)**

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statements to make economic decisions? Why or why not? If not, what changes do you recommend and why?

#### *Summary of the relevant proposals*

6. ED/2010/8 proposes a comprehensive measurement approach for all types of insurance contracts issued by insurers (and reinsurance contracts held by reinsurers), with a modified approach for some short-duration insurance contracts. Under the proposals, the insurance component of an insurance contract other than a short-duration contract would be measured using the following 'building blocks':
  - (a) probability-weighted expected future fulfilment cash flows (including incremental acquisition costs incurred to issue the contract);
  - (b) a discount rate that adjusts those cash flows for the time value of money;
  - (c) an explicit risk adjustment; and
  - (d) a residual margin (measured by reference to the initial premium to eliminate any 'day-one' gain on inception of the contract).
7. Apart from the residual margin, all of the building blocks would be subject to remeasurement and all remeasurement changes would be recognised in profit or loss when they arise. As discussed in paragraph 52 of this Agenda paper, ED/2010/8 proposes that the residual margin be released to profit or loss over the coverage period in a systematic way that best reflects risk exposure.
8. Insurance contracts create a bundle of rights and obligations that generate a package of cash flows and in some cases, some of the cash flows are unrelated to the provision of insurance coverage. These cash flows arise from components which, if issued as separate contracts, would be accounted for under different IFRSs, including:
  - (a) pure deposits, such as financial instruments whereby an entity receives a fixed sum and undertakes to repay that sum with interest;
  - (b) financial derivatives, such as interest rate options or options linked to an equity index; and
  - (c) non-insurance services, such as asset management or custody services.
9. Under the proposals in ED/2010/8, an insurer would unbundle a component of an insurance contract if the component is not closely related to the insurance coverage specified in the contract. The cash flows attributable to the individual component would be identified separately from the cash flows attributable to the insurance component and the insurer would apply the relevant IFRS to account for the unbundled component as if it were a separate contract.

10. ED/2010/8 proposes that short-duration insurance contracts are insurance contracts that meet both of the following conditions:
  - (a) the coverage period of the insurance contract is approximately one year or less; and
  - (b) the contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives (see paragraphs 99-104 of this Agenda paper for a more detailed discussion on the unbundling proposals).
11. For short-duration insurance contracts, an entity would apply:
  - (a) a premium allocation approach for pre-claims liabilities ('stand ready' obligations to meet valid claims for insured events that have not yet occurred); and
  - (b) the proposed comprehensive measurement approach for claims liabilities (obligations to meet valid claims for insured events that have occurred).
12. Consistent with the current approach under IFRS 4 *Insurance Contracts*, ED/2010/8 proposes that the:
  - (a) unearned premium amount of a short-duration insurance contract that is onerous be subject to remeasurement; and
  - (b) basis for remeasuring an onerous insurance contract be the present value of the fulfilment cash flows under the short-duration insurance contract. Accordingly, the remeasured amount of a portfolio of short-duration insurance contracts that are, as a whole, onerous would not include a risk adjustment.

*Staff analysis*

13. The proposed comprehensive measurement model would arguably facilitate insurers providing relevant information for decision making by users of an insurer's financial statements because:
  - (a) the proposed building blocks (see paragraph 6 above) are relevant for an understanding of the financial implications of most types of insurance contracts;
  - (b) claims liabilities for all types of insurance contracts would be measured on a consistent basis. However, under the proposals, pre-claims liabilities for short-duration insurance contracts would be measured on a different basis to pre-claims liabilities for long-duration insurance contracts (see paragraphs 70-75 of this Agenda paper); and
  - (c) insurance contract liabilities would be measured on a similar basis to other liabilities under IFRSs, such as defined benefit obligations and provisions.
14. Under the proposals in ED/2010/8, components of an insurance contract that are not subject to unbundling are accounted for as a part of the insurance contract. This approach raises the possibility that an insurer might not, for instance, account for an embedded derivative (such as a conversion option) in an insurance contract in the same way as an entity with a separate but otherwise identical derivative. However, as noted in paragraph BC79 of the ED, the proposed measurement model would facilitate

embedded derivatives being measured in substantially the same way, regardless of whether they are bifurcated, because:

- (a) the inputs used would generally be consistent with observable market variables, such as interest rates and market prices;
  - (b) it would capture both the intrinsic value of embedded options and guarantees and their time value;
  - (c) it would include a risk adjustment that reflects the uncertainty in future cash flows; and
  - (d) it recognises remeasurement changes in profit or loss when they arise.
15. A premium allocation approach would arguably also facilitate insurers providing relevant information for decision making by users in relation to the pre-claims liabilities for short-duration insurance contracts. However, a premium allocation approach is generally viewed as a cost-beneficial method of measuring specific types of insurance contract liabilities. Consequently, the proposal that an insurer be required (rather than permitted) to use a premium allocation approach (and thereby be prevented from using the proposed comprehensive measurement approach) to measure the pre-claims liabilities of some short-duration insurance contracts is inconsistent with the objective of the ED. In addition, the proposal that a short-duration insurance contract that is onerous be remeasured to an amount that does not include a risk adjustment is also arguably inconsistent with the objective of the ED.

***Staff views on IASB Question 1***

Staff **agree** that the proposed comprehensive measurement model would produce relevant information that will help users of an insurer's financial statements to make economic decisions for the reasons identified in paragraph 12 of this Agenda paper. **However**, as discussed in the remainder of this Agenda paper, staff consider that some of the proposals, particularly the proposals in relation to the residual margin, income statement presentation and transitional requirements, may reduce the relevance of the information for users.

In addition, staff **do not agree** that a premium allocation approach for short-duration insurance contracts would necessarily produce relevant information for decision making by users in all circumstances, such as when:

- (a) the proposed comprehensive measurement (building block) approach would provide more relevant information for users; and
- (b) the insurance contract is onerous.

**Question 2 – Fulfilment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51 of ED/2010/8)**

- (a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?
- (b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

*Summary of the relevant proposals*

16. ED/2010/8 proposes that insurers measure insurance liabilities using cash flows that will arise through fulfilment. Estimates of cash flows would include all cash flows within the boundary of an existing contract that are incremental at the level of a portfolio of insurance contracts. Paragraph B61 of Appendix B to ED/2010/8 provides examples of the types of cash flows relevant to measuring insurance contracts, including:
- (a) premiums;
  - (b) payments to (or on behalf of) policyholders;
  - (c) claim handling costs;
  - (d) cash flows that will result from options and guarantees embedded in the contract, to the extent those options and guarantees are not unbundled;
  - (e) incremental acquisition costs of selling, underwriting and initiating an insurance contract;
  - (f) policy administration and maintenance costs;
  - (g) transaction-based taxes and levies that arise directly from existing insurance contracts, or can be attributed to them on a reasonable and consistent basis;
  - (h) potential recoveries on future claims covered by existing insurance contracts; and
  - (i) payments to current or future policyholders as a result of a contractual participation feature.

*Staff analysis*

Question 2(a) – net fulfilment cash flows

17. The proposal to measure an insurance contract on the basis of the expected present value of the net future cash flows that will arise as the insurer fulfils the insurance contract is consistent with:
- (a) the way in which most insurers manage their insurance obligations. Insurers generally fulfil their liabilities to policyholders over time rather than transfer the liabilities to third parties or terminate contracts prior to completion;

- (b) the notion that an insurance contract is a bundle of rights and obligations that generally gives rise to a net obligation but may give rise to a net asset; and
  - (c) the way in which other similar liabilities are measured under IFRSs, such as defined benefit obligations, to the extent that current estimates of fulfilment cash flows are used.
18. The IASB's Discussion Paper *Preliminary Views on Insurance Contracts* (DP) proposed that insurers measure their insurance contracts at current exit value, which represents the amount the insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. Under this approach, the insurer would measure an insurance contract on the basis of market-consistent, probability-weighted and current estimates of the contractual cash flows.
19. Many respondents to the DP disagreed with a current exit value approach because:
- (a) it is not consistent with the way in which insurers manage their liabilities; and
  - (b) some types of cash flows, such as servicing costs, differ significantly between insurers, notwithstanding that insurers that issue similar insurance contracts would generally experience similar liability cash flows.

In light of these comments, the IASB decided to propose that insurers adopt a fulfilment value approach for measuring insurance contracts. ED/2010/8 proposes that estimates of non-market variables reflect all available evidence, both external and internal. Estimates for non-market (entity-specific) variables, such as future claims handling costs, would be adjusted for expected changes in the economic conditions if such variables had been found to be correlated in the past.

#### Question 2(b) – application guidance on future cash flows

The draft application guidance in Appendix B on estimates of future cash flows appears to be generally appropriate and sufficient.

#### ***Staff views on IASB Question 2***

Staff **agree** that the measurement of an insurance contract should include the expected present value of future cash flows that will arise as the insurer fulfils the insurance contract for the reasons described in paragraph 17 of this Agenda paper.

Staff **agree** that the draft application guidance in Appendix B on estimates of future cash flows to be generally appropriate and sufficient.

**Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104 of ED/2010/8)**

- (a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?
- (b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?
- (c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer?

*Summary of the relevant proposals*

- 20. ED/2010/8 proposes that an insurer adjust the future cash flows in relation to an insurance contract for the time value of money, using discount rates that:
  - (a) are consistent with observable current market prices for instruments with cash flows whose characteristics reflect those of the insurance contract liability, in terms of, for example, timing, currency and liquidity; and
  - (b) exclude any factors that influence the observed rates but are not relevant to the insurance contract liability (such as risks not present in the liability but present in the instrument for which the market prices are observed).
- 21. Under the proposals, if the cash flows of an insurance contract:
  - (a) do not depend on the performance of specific assets, the discount rate would reflect the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk (risk-free rate), with an adjustment for illiquidity; or
  - (b) depend wholly or partly on the performance of specific assets, the measurement of the insurance contract would reflect that dependence. To this end, the ED proposes that, in some circumstances, the most appropriate way to reflect that linkage might be to use a replicating portfolio technique.
- 22. With respect to the proposal for discount rates to include, when appropriate, a liquidity adjustment, paragraph 34 of ED/2010/8 states that:

“Many insurance liabilities do not have the same liquidity characteristics as assets traded in financial markets. For example, some government bonds are traded in deep and liquid markets and the holder can typically sell them readily at any time without incurring significant costs. In contrast, policyholders cannot liquidate their investment in some insurance contract liabilities without incurring significant costs, and in some cases they have no contractual right to liquidate their holding at all. Thus, in estimating

discount rates for an insurance contract, an insurer shall take account of any differences between the liquidity characteristics of the instruments underlying the rates observed in the market and the liquidity characteristics of the insurance contract.”

*Staff analysis*

Question 3(a) – discount rate for non-participating contracts

23. The notion that an entity should discount a liability that is not linked to an asset or group of assets at a rate that reflects the characteristics of the liability and not those of the assets backing that liability is generally accepted within IFRSs. There are a number of reasons for this, including:
- (a) such an approach would facilitate the provision of more relevant information for users regarding insurance contract liabilities; and
  - (b) using an expected earnings rate to discount non-participating contracts is likely to give rise to anomalous reporting outcomes. For instance, by investing in assets with higher expected returns (and therefore presumably higher risks), the insurer could reduce the measured amounts of its insurance contract liabilities, even when the insurance risks to which it is exposed have remained the same or increased.

Question 3(b) – illiquidity premium

24. As noted by the IASB in paragraphs BC100 and BC101 of ED/2010/8:
- (a) there is currently no general consensus among practitioners on how to measure an illiquidity premium, particularly how to separately measure illiquidity from credit effects; and
  - (b) its decision not to provide detailed guidance in the ED on the determination of an illiquidity premium is consistent with a principle-based approach to standard setting, and preparers, accountants and actuaries are currently examining ways of determining an illiquidity premium for insurance liabilities.
25. During 2008 and 2009, the IASB conducted field tests covering both the IASB’s and FASB’s tentative decisions in relation to a range of topics on accounting for insurance contracts. In response to the proposals on discount rates, most participants indicated that they currently incorporate the impacts of liquidity into the measurements of their insurance liabilities in a number of different ways, including:
- (a) adjusting discount rates observed for liquid assets to match the characteristics of the liabilities (primarily for annuity insurance liabilities that are backed by assets held until maturity);
  - (b) using market yields on high quality corporate bonds as a proxy for a discount rate that reflects the liquidity characteristics of insurance liabilities; or

- (c) calculating an explicit liquidity premium using, for instance, a replicating portfolio.<sup>1</sup>
26. These findings from the IASB's field tests arguably reflect international concerns regarding the valuation of liabilities generally. For instance:
- (a) in April 2009, the ad hoc Risk Margin Working Group of the International Actuarial Association published a research paper titled *Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins*. The research paper notes that: "...to the extent that it is appropriate for discount rates to be based on the liquidity characteristics of the expected cash flows inherent in the liability..., the discount rates instead should correspond to interest rates that are somewhat greater, that is, based on securities that are less liquid than the risk free securities";<sup>2</sup>
  - (b) in October 2009 the European Insurance CFO Forum<sup>3</sup> issued an update to its Market-Consistent Embedded Value principles (MCEV Principles). The original MCEV Principles did not permit the reference (discount) rate to be adjusted to reflect the effects of liquidity. However, in response to the extreme market conditions experienced in 2007 and 2008, the European Institute CFO Forum revised its MCEV Principles to permit the use of a liquidity premium in the discount rate of liabilities that are not liquid; and
  - (c) in its *Information Note: Risk-free Discount Rates under AASB 1038* (March 2010), the Life Insurance and Wealth Management Practice Committee (LIWMPC) of the Institute of Actuaries of Australia (IAA) proposed that, in determining the present value of a life insurance liability under AASB 1038 *Life Insurance Contracts*, the features of the liability cash flows should be considered and, when appropriate, an illiquidity margin should be added to the default-risk adjusted rate. The LIWMPC also notes that liquidity premiums are likely to vary over time and with the nature of insurance liabilities.

Question 3(c) – proposed discount rate for long-duration insurance contracts

27. There are a number of arguments in favour of discounting non-participating insurance liabilities using discount rates derived from the expected return on plan assets backing the liabilities. For instance, such an approach:
- (a) is consistent with some pricing practices;
  - (b) prevents recognition of losses at inception; and

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1 Agenda paper 14F/39F *Insurance Contracts – Targeted Field Test Results*, IASB/FASB Joint meeting, February 2010, paragraphs 36 and 37.

2 *Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins* (April 2009), page 55.

3 The European Institute CFO Forum was created in 2002 as a high-level discussion group. The Forum is attended by the Chief Financial Officers of major European listed, and some non-listed, insurance companies. Its aim is to influence the development of financial reporting, value-based reporting and related regulatory developments for insurance enterprises on behalf of its members.

- (c) avoids the volatility (and accounting mismatches) that would arise if short-term fluctuations in asset spreads affect the measurement of the assets, but not the measurement of the liabilities.
28. Such an approach, however, does not distinguish an insurer's investment performance from its underwriting performance. Accordingly, discounting non-participating insurance contracts at expected investment earnings rates it is inconsistent with:
- (a) the proposal in ED/2010/8 that an insurer unbundle a component of an insurance contract if the component is not closely related to the insurance coverage specified in the contract; and
  - (b) the measurement approaches applicable to other similar liabilities under IFRSs, such as defined benefit obligations and provisions.

### *Staff views on IASB Question 3*

Staff:

- (a) **agree** with the proposals that the discount rate used by an insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability for the reasons discussed in paragraph 24 of this Agenda paper;
- (b) **agree** with the proposals for an insurer to include, when appropriate, an illiquidity premium in the discount rate for insurance contract liabilities and with the guidance on liquidity for the reasons discussed in paragraphs 25-28 of this Agenda paper; and
- (c) **disagree** with the suggestion that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts for the reasons noted in paragraph 30 of this Agenda paper.

In addition, staff **do not agree** that the IASB should reconsider its conclusion that the present value of the fulfilment cash flows should not reflect the risk of non-performance by the insurer because a change in an insurer's own credit risk is not relevant when the approach is based on the insurers fulfilling their insurance contract liabilities.

### **Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115 of ED/2010/8)**

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

### *Summary of the relevant proposals*

29. The FASB has concluded that the comprehensive measurement model for insurance contracts should not include a separate risk adjustment and residual margin, but should instead combine these in a single composite margin. Accordingly, under the FASB's proposed approach, an insurer would not measure or disclose a separate risk adjustment

for an insurance contract, and the composite margin would not be subject to remeasurement if and when the underlying risks of an insurance contract change. In addition, the composite margin would be released to profit or loss over both the coverage period and the claims handling period of the insurance contract.

*Staff analysis*

30. There are a number of arguments in favour of a composite margin approach for insurance contracts, including:
  - (a) there is currently no single technique for developing risk adjustments that is universally used and accepted, which would limit the comparability of the financial statements between insurers and over time;
  - (b) risk adjustment information arguably does not provide cost-beneficial information;
  - (c) some argue that it is currently not possible to perform direct back-tests to assess retrospectively whether a particular risk adjustment was reasonable. Accordingly, it may not be feasible to assess whether, for instance, a decision to set a confidence level at a particular percentile was appropriate; and
  - (d) it is consistent with the IASB's proposals in ED/2010/6 *Revenue from Contracts with Customers*.
  
31. There are also a number of arguments in favour of including a separate risk adjustment in the measurement of an insurance contract, including:
  - (a) it would result in an explicit measurement of risk that provides a clearer insight into the core activity of an insurer;
  - (b) it would ensure that the measurement of an insurance liability includes a risk adjustment, which is essential to distinguishing risk-generating liabilities from risk-free liabilities. In contrast, a single composite margin reflects the insurer's pricing policy and may not correspond to the degree of risk present in the liability both at inception and throughout the contract term;
  - (c) it is conceptually consistent with market valuations of financial instruments and their pricing, which reflect the degree of risk associated with the instrument; and
  - (d) it would facilitate the risk adjustment component of an insurance liability being run-off over the period the insurer is 'on risk' (claims period) rather than over both the claims and coverage periods (as would be the case under a composite margin approach).
  
32. Staff also consider it essential that the risk adjustment be subject to remeasurement, which is explicitly within the IASB's proposals. As is evident in markets for insurance contracts, the price of risk changes as new information becomes available and as underlying conditions change.

***Staff views on IASB Question 4***

Staff **agree** with the IASB's proposals for an insurer to measure claims liabilities in relation to insurance contracts using an explicit risk adjustment and residual margin as opposed to the FASB's composite margin approach because the IASB's proposals:

- (a) would arguably provide more useful information to users of an insurer's financial statements about the insurer's perceptions of the effects of uncertainty on the amount and timing of future claims liability cash flows. Under the FASB's composite margin approach, a risk adjustment would not be separately calculated and therefore not disclosed in an insurer's financial statements. Moreover, under the FASB's approach, the risk adjustment would not be subject to remeasurement, which is inconsistent with the nature of insurance contracts and recent experiences that suggest market perceptions of risk can change rapidly;
- (b) are consistent with the economics of insurance contracts in the sense that insurers generally price insurance contracts to reflect the underlying insurance risks. Moreover, where an insurer has not included a risk adjustment in its claims liabilities, this would be reported under the IASB's proposals whereas it would not be reported under the FASB's composite margin approach;
- (c) are consistent with its proposals in ED/2010/1 *Measurement of Liabilities in IAS 37 – Proposed amendments to IAS 37*. However, it is relevant to note that, at its September 2010 meeting, the IASB decided to reconsider the proposal to require a risk adjustment to be included in the measurement of a liability under a revised version of *IAS 37 Provisions, Contingent Liabilities and Contingent Assets*; and
- (d) as demonstrated by insurers reporting under AASB 1023 *General Insurance Contracts*, a risk adjustment can be reliably determined for an insurance contract.

**Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123 of ED/2010/8)**

- (a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?
- (b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?
- (c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?
- (d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?
- (e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

*Summary of the relevant proposals*

- 33. ED/2010/8 proposes that the risk adjustment included in the measurement of an insurance contract liability represents the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected. Accordingly, the risk adjustment would:
  - (a) be subject to remeasurement; and
  - (b) decline as the insurer is released from risk (usually over time).
- 34. To achieve the proposed objective of a risk adjustment, an insurer is required to use only one of the following techniques:
  - (a) confidence level;
  - (b) conditional tail expectation; or
  - (c) cost of capital.

Confidence level

- 35. The confidence level technique [sometimes referred to as Value at Risk (VAR)] expresses uncertainty in terms of the extra amount that must be added to the expected value so that the probability that the actual outcome will be less than the amount of the

liability (including the risk adjustment) equals the target level of confidence. The probability of adequacy approach required under AASB 1023 *General Insurance Contracts* is a confidence level technique.

36. The confidence level technique is relatively easy to calculate and provides useful information that users with a moderate understanding of statistical methods can understand. However, the usefulness for users of a risk adjustment calculated using the confidence level technique tends to diminish as the probability distribution of expected claims outcomes become less normally distributed (which is often the case for non-life insurance contracts). In circumstances where the probability distribution of outcomes is highly skewed, or there exists extremely large but highly unlikely losses in the 'tail' of the probability distribution beyond the specified confidence level, the confidence level technique may not adequately capture these losses in the risk adjustment.

#### Conditional tail expectation

37. A conditional tail expectation technique (CTE) (also referred to as a tail conditional expectation or a tail value at risk technique) provides a better reflection of the potentially extreme losses in the tail of a distribution (caused by events such as natural disasters) than the confidence level technique, provided that the probability distribution is not highly skewed. It does this by calculating the mean of losses within a certain band of pre-defined percentiles within the probability distribution. Accordingly, a risk adjustment measured using CTE is calculated as the probability weighted average of all scenarios in the tail of the distribution less the mean estimate.

#### Cost of capital

38. A cost of capital technique provides an estimate of the amount of capital an insurer would need to hold to provide a high degree of certainty that it could fulfil its obligations to policyholders under existing insurance contracts. To apply a cost of capital technique, an insurer would:
- (a) set a confidence level from the estimated probability distribution for claims that provides a high degree of certainty that it would be able to fulfil its insurance obligations;
  - (b) determine the difference between the amount of estimated value of claims at the confidence level established in (a) and the expected value of claims for the entire probability distribution. The difference represents the capital amount that corresponds to the high degree of certainty that the insurer will be able to fulfil its obligations to policyholders; and
  - (c) estimate the risk adjustment by applying an annual rate of return to the capital determined in (b) for each period of the insurance contracts and, when capital is required to be held in future periods, adjust the risk adjustment for the time value of money.
39. To meet the objective of the risk adjustment in ED/2010/8, paragraph B88 states, in part, that:

“...both the amount of capital and the capital rate need to be derived in an appropriate way, as follows:

- (a) the amount of capital shall be set at a sufficiently high level that it captures almost the entire tail of the distribution. To do this, an insurer would need to identify how much uncertainty exists in the tail of the distribution.
- (b) the capital rate shall reflect the risks that are relevant to the liability (ie those risks the owners of the insurer would require for exposure to the risk in the liability), but not reflect risks that are not relevant to the liability (eg asset risk for non-participating insurance contracts and avoidable mismatch risk) or those risks that are already captured elsewhere in the model...”

#### Diversification benefits

40. With respect to the extent to which diversification benefits are included in the risk adjustment, paragraph 36 of ED/2010/8 proposes that:

“An insurer shall estimate the risk adjustment at the level of a portfolio of insurance contracts. Therefore, the risk adjustment shall reflect the effects of diversification that arise within a portfolio of insurance contracts, but not the effects of diversification between that portfolio and other portfolios of insurance contracts.”

#### Application guidance

41. To assist preparers and auditors in applying the risk adjustment proposals, and users in understanding the risk adjustment, paragraph B72 of Appendix B to ED/2010/8 proposes that a risk adjustment shall, to the extent practicable, have the following characteristics:
- (a) risks with low frequency and high severity will result in higher risk adjustments than risks with high frequency and low severity;
  - (b) for similar risks, contracts with a longer duration will result in higher risk adjustments than those of a shorter duration;
  - (c) risks with a wide probability distribution will result in higher risk adjustments than those risks with a narrower distribution;
  - (d) the less that is known about the current estimate and its trend, the higher the risk adjustment shall be; and
  - (e) to the extent that emerging experience reduces uncertainty, risk adjustments will decrease and *vice versa*.

*Staff analysis*

Question 5(a) – nature of the proposed risk adjustment

42. There are a number of arguments in favour of the risk adjustment depicting the amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected, including:
- (a) it would provide useful information to users of an insurer's financial statements about the insurer's perceptions of the effects of uncertainty on the amount and timing of future claims liability cash flows;
  - (b) it is consistent with the underlying principle of the proposed model, which is to measure the ultimate cost an insurer expects to incur in fulfilling its obligations under an insurance contract; and
  - (c) it is consistent with the IASB's proposals in ED/2010/1 *Measurement of Liabilities in IAS 37 – Proposed amendments to IAS 37*.
43. The main argument against the proposed risk adjustment is that it would be inconsistent with the market participant perspective of risk required in the context of similar contracts measured at fair value under IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*. However, calculating a risk adjustment for an insurance contract on the basis of the compensation a market participant would require for bearing the risk associated with the contract would be inconsistent with the fulfilment value measurement objective of ED/2010/8.

Question 5(b) – proposed limitation on the choice of techniques for estimating the risk adjustment

44. Each of the proposed techniques for estimating risk (confidence level, conditional tail expectation (CTE) and cost of capital) would arguably facilitate the measurement of a risk adjustment in accordance with the proposed risk adjustment principle. However, limiting an insurer to measuring a risk adjustment to only one of these techniques is arguably inconsistent with principle-based standard setting. Moreover, if improved risk measurement techniques were developed subsequent to the replacement Standard for IFRS 4 being issued, insurers would presumably not be permitted to use these new techniques under the replacement Standard.

Question 5(c) – whether an insurer should disclose the equivalent confidence level if it uses the CTE or cost of capital technique

45. Requiring an insurer that uses either the CTE or cost of capital techniques to disclose the confidence level to which the risk adjustment corresponds has a number of advantages, including:
- (a) assisting users, particularly users in jurisdictions where the confidence level technique (or similar techniques) is widely used, in understanding insurance contract liabilities recognised by insurers using the CTE or cost of capital techniques; and

- (b) enhancing the comparability of financial statements between insurers and over time. Increasing uncertainty about the amount and timing of the cash flows arising from an insurance contract would generally increase the amount an insurer would pay to be relieved of the uncertainty. However, insurers are likely to pay different amounts to be relieved of similar risks because they have different risk appetites. The confidence level technique provides a measure of an insurer's risk appetite. Accordingly, to compare the insurance contract liabilities of different insurers, users need to understand how the risk adjustments calculated by different insurers have been affected by the insurer's risk appetite.
46. Nevertheless, some argue that the requirement for insurers that use the CTE or cost of capital techniques to disclose the confidence level to which the risk adjustment corresponds may:
- (a) create an incentive for insurers to adopt the confidence level technique generally, which may not be appropriate in some circumstances. As noted in paragraphs B94-B102 of ED/2010/8, the confidence level technique may not be appropriate when the probability distribution of expected claims is skewed and/or varies significantly over time; and
  - (b) be misleading, particularly in circumstances where a confidence level technique is not appropriate.

Question 5(d) – measuring the risk adjustment at the portfolio level

47. The proposal that risk adjustments be measured at the portfolio (unit of account) level is consistent with the approaches adopted under IAS 39 and IFRS 9 with respect to classifying financial instruments. However, ED/2010/8 proposes that different features of an insurance liability be measured at different levels of aggregation. For instance, acquisition costs are to be determined at the individual contract level whereas residual margins are to be determined at a level that aggregates insurance contracts into a portfolio and, within each portfolio, by similar date of contract inception and coverage period. Accordingly, some argue that insurance contracts would be measured under the proposals in ED/2010/8 using building blocks that are not comparable because they have been determined at different levels of aggregation.
48. In addition, some argue that ED/2010/8 does not make a sufficiently strong case for prohibiting an insurer from determining a risk adjustment on a basis that reflects its business as a whole (in which case the risk adjustment would include diversification benefits across portfolios), particularly as most insurers and reinsurers (as noted in paragraph BC236(b) of ED/2010/8) manage their insurance portfolios on an entity-wide basis.
49. The IASB cites the lack of 'fungibility' of surpluses and deficiencies across insurance portfolios as the main reason why insurers should be prohibited from determining risk adjustments at an entity level. Paragraph BC119(b) of ED/2010/8 states that:
- “Determining risk adjustments directly for a legal entity or for the entire reporting entity. However, this approach would require the insurer to undertake one of the following:

- (i) to assume that all portfolios within that entity are fungible, ie that a surplus in one portfolio is available in full to cover a deficit in another portfolio. In the Board's view, this would be inappropriate because complete fungibility is rare in practice, for legal and regulatory reasons.
  - (ii) to consider the degree of fungibility in estimating the probability distribution. In the Board's view, this would be a difficult and burdensome exercise and would be so reliant on difficult judgements that it would not produce information that is relevant or represents faithfully the degree of fungibility that exists."
50. As noted above, determining risk adjustments on an entity-wide basis is arguably not consistent with the approach required under other IFRSs. However, it is relevant to note that:
- (a) the IASB regards diversification benefits across portfolios as relevant to the accounting for reinsurance contracts. For instance, paragraph BC236(b) of ED/2010/8 states, in part, that:
    - “...The Board considered whether the residual margin in the reinsurance contract could be negative if, in rare cases, the amount paid by the cedant is less than the expected present value of cash flows plus the risk adjustment. The Board noted that the most likely causes of such a negative difference would be:
      - (a) ...;
      - (b) favourable pricing by the reinsurer, for example as a result of diversification benefits. The Board concluded that the recognition of a gain would be appropriate in such cases. This is because doing so is consistent with the Board's conclusion that the residual margin for the underlying contract should not be negative (although for the underlying contract the consequence is the immediate recognition of a loss, rather than the immediate recognition of a gain)”; and
  - (b) some argue a lack of ‘fungibility’ is not a relevant justification for prohibiting risk adjustments from reflecting diversification benefits across an insurer's portfolios, particularly portfolios that are not subject to the same types of regulatory controls that statutory funds typically are. Moreover, while an insurer may not be able to offset any surpluses and deficiencies across portfolios by transferring assets and liabilities between portfolios, the insurer would generally be able to mitigate the effects of such imbalances practically through the use of borrowings.

### **Staff views on IASB Question 5**

Staff:

- (a) **agree** with the proposal that the risk adjustment should depict the amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected because:
- (i) it would provide useful information to users of an insurer's financial statements about the insurer's perceptions of the effects of uncertainty on the amount and timing of future claims liability cash flows; and
  - (ii) it is consistent with the underlying principle of the proposed model.

In addition, staff note that the risk adjustment proposals in ED/2010/8 are consistent with the IASB's proposals in ED/2010/1 *Measurement of Liabilities in IAS 37 – Proposed amendments to IAS 37*. However, the AASB did not agree with the proposals in ED/2010/1;

- (b) **agree** with the proposed techniques for estimating risk adjustments (confidence level, CTE and cost of capital techniques) but disagree with the proposal to limit the techniques to only those three identified because such an approach:
- (i) is inconsistent with principle-based standard setting; and
  - (ii) would potentially prevent insurers using new and better risk measurement techniques in the future.

Staff **consider** that the replacement Standard for IFRS 4 should contain a rebuttable presumption that an insurer would be required to use one of the three identified techniques unless another method provides a more relevant and/or reliable measure of the risk adjustment;

- (c) on balance, **agree** with the proposal that, if either the CTE or the cost of capital technique is used, the insurer should disclose the confidence level to which the risk adjustment corresponds because it would:
- (i) assist users, particularly those in jurisdictions where the confidence level technique (or similar techniques) is widely used; and
  - (ii) enhance the comparability of financial statements between insurers and over time;
- (d) **disagree** with the proposal that an insurer should measure the risk adjustment at a portfolio level of aggregation because:
- (i) it is inconsistent with the way many insurers manage their insurance portfolios;
  - (ii) it is inconsistent with the ED's acknowledgement that diversification benefits across portfolios are relevant to the accounting for reinsurance contracts; and
  - (iii) 'fungibility' is arguably not a relevant justification for prohibiting the risk adjustment from reflecting diversification benefits across an insurer's portfolios, particularly for insurers that do not have statutory funds or can mitigate the effects of having surpluses and deficits across their portfolios through the use of borrowings.

In addition, the ED proposes that insurers aggregate risk adjustments at a different level to incremental acquisition costs and residual margins. Accordingly, staff **consider** that the IASB should give further consideration to the implications of requiring an insurer to measure insurance contracts using building blocks that have been determined at different levels of aggregation; and

- (e) **agree** that the draft application guidance in Appendix B on risk adjustments is appropriate and sufficient.

**Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133 of ED/2010/8)**

- (a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?
- (b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?
- (c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?
- (d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?
- (e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?
- (f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

*Summary of the relevant proposals*

51. ED/2010/8 proposes that an insurance contract be initially measured at the sum of the present value of the fulfilment cash flows (probability-weighted expected future fulfilment cash flows plus a risk adjustment, adjusted for the time value of money) and a residual margin that eliminates any gain at inception of the contract. A residual margin could arise because the price of the insurance contract:
- (a) includes non-incremental acquisition costs;
  - (b) includes compensation for developing and originating the contract;
  - (c) includes compensation for providing other services and/or having superior distribution arrangements (selling margin);
  - (d) reflects the risk that the insurer might not satisfy its obligation to perform under the insurance contract; and/or
  - (e) includes measurement errors.

52. In contrast to the treatment of risk adjustments, ED/2010/8 proposes that a residual margin determined at the inception of an insurance contract be recognised as income in profit or loss over the coverage period in a systematic way that best reflects the insurer's exposure from providing insurance coverage:
- (a) on the basis of the passage to time, but
  - (b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.
53. In addition, ED/2010/8 proposes that an insurer:
- (a) determine the residual margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period; and
  - (b) accrete interest on the carrying amount of the residual margin using the proposed discount rate as determined at initial recognition, updated in each reporting period.
54. In circumstances where the residual margin is 'less than zero' at inception (that is, the expected present value of the future fulfilment cash outflows plus a risk adjustment is greater than the expected present value of the future cash inflows under the contract), the residual margin would be recognised as a loss in profit or loss immediately.

*Staff analysis*

Question 6(a) – recognition of a gain on inception of an insurance contract

55. As noted above, residual margins sometimes comprise compensation for developing and originating the contract, providing services under the insurance contract or for having superior distribution arrangements. Accordingly, requiring insurers to recognise a residual margin as income over the coverage period of the insurance contract would arguably be inconsistent with the proposals in the IASB's Exposure Draft ED/2010/6 *Revenue from Contracts with Customers*.

Question 6(b) – residual margin can be less than zero

56. As noted in paragraph 54 of this Agenda paper, a residual margin would be less than zero at inception when the expected present value of the future fulfilment cash outflows plus a risk adjustment is greater than the expected present value of the future cash inflows under the contract (onerous contract). Accordingly, recognising a residual margin as a loss in profit or loss in such circumstances would be consistent with:
- (a) the recognition of losses in respect of onerous contracts under other IFRSs such as IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and
  - (b) the prospective measurement basis proposed in ED/2010/8.

Question 6(c) – level of aggregation for residual margins

57. As noted in paragraph 47 of this Agenda paper, the proposal that residual margins be aggregated at a portfolio level is inconsistent with the proposed levels of aggregation for acquisition costs and risk adjustments. As the residual margin is a product of the other building blocks, it might be argued that, in principle, the residual margin should be determined at the portfolio level, which would be consistent with the approach proposed with respect to the expected cash flows and risk adjustments.
58. The proposal that residual margins be aggregated on the basis of portfolios of contracts that have similar dates of inception and similar coverage periods also helps to enforce the notion that residual margins are ‘locked in’ (probably year-by-year), thereby facilitating application of proposal to systematically run residual margins off to profit or loss. However, as noted in Staff views on IASB Question 6 (page 25 of this Agenda paper), staff do not agree with the IASB’s proposals regarding the release of residual margins, primarily because prohibiting residual margins to be subject to remeasurement:
- (a) is inconsistent with the proposed treatment of such margins at inception;
  - (b) would cause profit recognition to be influenced more by the assumptions used to measure insurance contract liabilities than actual experience;
  - (c) would give rise to anomalous outcomes in some relatively common circumstances; and
  - (d) is arguably not justified if the IASB’s intention is to prevent insurer’s managing profits recognised on insurance contracts as reliable information in the form of market prices would be readily available for most types of insurance contracts.
59. If the IASB decided that residual margins should be subject to remeasurement (and therefore portfolios of insurance contracts could be considered ‘open’ to the extent that date of inception is not relevant for the purpose of identifying the boundary of a portfolio of insurance contracts), staff consider that the criteria for similar coverage period would be arguably sufficient for determining the level of aggregation for residual margins, provided that portfolios comprise insurance contracts with similar terms and conditions.

Question 6(d) – proposed method of releasing residual margins

60. There are a number of arguments against the proposed method of releasing the residual margin, including:
- (a) it is inconsistent with the proposed treatment of such margins at inception. At inception, the measured amount of an insurance contract would reflect the entity’s best estimate of the current (fulfilment) value of the insurance contract and any unearned profits in the form of margins (risk and residual). Accordingly, the margin could be thought of as representing a current value margin. However, by ‘locking in’ any residual margins at inception, insurance contracts would be subsequently measured using a model that is arguably more ‘mixed’ in nature [comprising both prospective (value) and historical (cost) components] than the model used at inception;

- (b) it would give rise to seemingly anomalous outcomes in some relatively common circumstances. For instance, an adverse change in the expected future fulfilment cash flows of a portfolio of insurance contracts would be recognised immediately in profit or loss. However, under the proposals any residual margin attributable to the contracts at inception would continue to be recognised systematically as gains in profit or loss over the remaining coverage period; and
- (c) profit recognition would potentially be influenced more by the assumptions used to measure insurance contract liabilities than actual experience. For long-duration insurance contracts, the present values of the future components of an insurance contract liability (future premiums, claim expenses, risk adjustment and residual margin) will generally be large relative to claims, expenses, risk adjustments and residual margins reported and/or released in the current profit reporting period. Accordingly, requiring the residual margin to be run-off over the coverage period could cause the reported profits in earlier periods to be dominated by changes in estimates of future components of the insurance contract liability.
61. The main argument in favour of the proposed method of releasing residual margins is that it would not be as subject to manipulation as a remeasurement approach. However, in many circumstances, insurers would be selling policies with similar terms and conditions year after year. On this basis, information for remeasuring residual margins in the form of market prices would be readily available for most types of insurance contracts and therefore concerns about manipulation in the absence of verifiable benchmarks may not be well founded.
62. It is also relevant to note that, if adopted in the context of the other proposals in ED/2010/8, the remeasurement of residual margins would only impact on long-duration insurance contracts, such as life contracts.

Question 6(e) – proposed method for releasing a composite margin

63. The FASB proposes that the composite margin be amortised over the coverage period and the claims handling period according to the following formula, which is intended to approximate the pattern of the decline of risk that the insurer is subject to under the contract:

$$\frac{\text{Premium allocated to current period} + \text{Current period claims and benefits}}{\text{Total contract premium} + \text{Total claims and benefits}}$$

64. Amortising the composite margin over the coverage period and the claims handling period is consistent with the nature of the margin. As the risk and residual components of the margin are not separately calculated, amortising both components together over the total period of the contract is arguably appropriate. In addition, as the risk adjustment is likely to be the most significant component of a composite margin, it is arguably appropriate that the composite margin be amortised in accordance with the insurer being released from risk.

Question 6(f) – interest accreted on the residual margin

65. The residual margin is a part of the insurance contract liability. As interest would be accreted on other parts of an insurance liability, for consistency interest should also be accreted on the residual margin.

***Staff views on IASB Question 6***

Staff:

- (a) **agree** with the proposal to prohibit an insurer from recognising any residual margin as a gain at initial recognition of an insurance contract because residual margins generally comprise profit that will be earned over the term of the contract and recognising such profit at inception would be inconsistent with the treatment of similar contracts under other IFRSs;
- (b) **agree** with the proposal that an insurer recognise a negative residual margin at initial recognition of an insurance contract as a loss immediately in profit or loss because such an approach is consistent with the treatment of onerous contracts under other IFRSs and with the prospective measurement approach proposed in the ED;
- (c) **disagree** with the proposal that an insurer estimate the residual margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period because of the reasons discussed in (d) below;
- (d) **disagree** with the proposed method of releasing residual margins because:
  - (i) it is inconsistent with the proposed treatment of such margins at inception;
  - (ii) profit recognition would potentially be influenced more by the assumptions used to measure insurance contract liabilities than actual experience;
  - (iii) it would give rise to anomalous outcomes in some relatively common circumstances; and
  - (iv) reliable information for remeasuring residual margins in the form of market prices would be readily available for most types of insurance contracts.

Accordingly, staff **consider** that:

- (v) residual margins should be subject to remeasurement on the basis of changes in estimates of non-market variables (non-financial assumptions) that have an impact on the expected net fulfilment cash flows in future periods; and
  - (vi) if residual margins are subject to remeasurement, the criteria for similar coverage period would be arguably sufficient for aggregating residual margins in relation to ‘open’ portfolios of insurance contracts, provided that the portfolios comprise insurance contracts with similar terms and conditions;
- (e) **agree** that the proposed method of releasing the composite margin is consistent with the nature of such a margin. However, as noted in staff views to IASB Question 4, staff favour an explicit risk adjustment and residual margin approach over a composite margin approach; and
  - (f) **agree** with the proposal for interest to be accreted on the residual margin because it is a part of an insurance contract liability and other parts of the liability are subject to the accretion of interest.

**Question 7 – Acquisition costs (paragraphs 24, 39 and BC135–BC140 of ED/2010/8)**

Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

*Summary of the relevant proposals*

66. Appendix A of ED/2010/8 defines incremental acquisition costs as:
- “the costs of selling, underwriting and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, but no other direct and indirect costs.”
67. Under the proposals in the ED, an insurer would:
- (a) recognise all acquisition costs other than incremental acquisition costs as an expense when incurred; and
  - (b) include incremental acquisition costs in the initial measurement of the present value of future cash flows under the contract (and therefore affect profit or loss over the coverage period).

*Staff analysis*

68. There are a number of arguments in favour of including incremental acquisition costs in the contract cash outflows, including:
- (a) insurance contracts are generally priced to recover at least incremental acquisition costs. Accordingly, including incremental acquisition costs in the contract cash outflows would facilitate the recognition of residual margins at amounts that are more reflective of their actual amounts;
  - (b) consistency with the treatment of incremental costs under IAS 39 and IFRS 9; and
  - (c) consistency with the approach to costs of securing a right to provide investment management services, as described in the illustrative examples accompanying IAS 18 *Revenue*. However, under the proposals in the IASB’s Exposure Draft ED/2010/6 *Revenue from Contracts with Customers*, that right would no longer be recognised as an asset, and the incremental costs of securing it would be recognised as an expense as incurred.
69. There are also a number of arguments against including incremental acquisition costs in the contract cash outflows, including:
- (a) an insurer typically will price an insurance contract to recover not only incremental costs, but also other direct and indirect costs. Accordingly, permitting only incremental acquisition costs to be included in contract cash outflows is arguably arbitrary and not consistent with the underlying economics of some insurance contracts; and

- (b) the definition of incremental acquisition costs is too narrow to reflect adequately the various sales structures of insurers. For instance, it may result in different answers for sales structures that have the same cost level but use different channels (external agents versus direct writing). Moreover, the proposals may encourage insurers to arrange their sales structures to enable them to include costs that would otherwise be expensed immediately in contract cash outflows. For instance, by moving from direct writing arrangements to external agents, or by transferring their direct writing arrangements into a separate entity and having the entity charge the insurer on a 'per contract' basis.

***Staff views on IASB Question 7***

On balance, staff **agree** with the proposal to include only incremental acquisition costs in the initial measurement of the insurance contract as contract cash outflows because:

- (a) insurers generally factor such costs into the prices of their insurance contracts;
- (b) such an approach is likely to provide a more realistic depiction of profit over the life of the contract; and
- (c) such an approach is consistent with the treatment of acquisition costs in relation to similar types of contracts under other IFRSs.

**However**, consistent with staffs' views in relation to Questions 5 and 6, staff consider that the IASB should give further consideration to requiring insurance contracts to be measured using building blocks that have been determined at the same level of aggregation. ED/2010/8 proposes that the building blocks be determined at different levels of aggregation and staff are concerned that this approach could undermine the usefulness of the resulting information for users of an insurer's financial statements.

Staff **agree** that non-incremental acquisition costs and acquisition costs relating to unsuccessful underwriting efforts should be recognised as expenses when incurred because such an approach is consistent with the treatment of similar costs under other IFRSs.

**Question 8 – Premium allocation approach (paragraphs 54-60 and BC145-BC148 of ED/2010/8)**

- (a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?
- (b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

*Summary of the relevant proposals*

- 70. As discussed in paragraphs 10-12 of this Agenda paper, ED/2010/8 proposes that pre-claims liabilities in relation to short-duration insurance contracts be measured using a premium allocation model. Consistent with other proposals in the ED, a short-duration insurance contract would be measured at inception at the amount of any premium received *plus* the expected present value of any future premiums that are within the boundary of the existing contract *less* any incremental acquisition cost.
- 71. Short-duration insurance contracts are insurance contracts that meet both of the following conditions:
  - (a) the coverage period of the contract is approximately one year or less; and
  - (b) the contract does not contain embedded options or other derivatives that significantly affect the variability of cash flows, after unbundling any embedded derivatives (see paragraphs 99-104 of this Agenda paper for a more detailed discussion on the unbundling proposals).
- 72. Subsequent to inception, an insurer would reduce the measurement of the pre-claims obligation over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:
  - (a) on the basis of the passage of time, but
  - (b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

In addition, the insurer would accrete interest on the carrying amount of the pre-claims liability, using the proposed discount rate, updated in each reporting period.
- 73. Under the proposals in the ED, an insurer would be required to consider, at initial recognition and subsequently, whether an insurance contract is onerous. That is, whether the present value of the fulfilment cash flows relating to future insured claims that are within the boundary of an existing short-duration contract exceeds the carrying amount of the pre-claims obligation. If an insurance contract is onerous, the insurer would:
  - (a) aggregate the insurance contracts into a portfolio and, within a portfolio, by similar date of inception; and

- (b) recognise an additional liability and a corresponding expense, measured as the difference between the carrying amount of the pre-claims liabilities and the present value of the fulfilment cash flows (not including a risk adjustment).

*Staff analysis*

74. Under the proposals in the ED, short-duration insurance contracts would be required (rather than permitted) to be measured using a premium allocation model. The IASB notes that the proposed approach helps ensure comparability between the financial statements of different insurers. However, requiring (rather than permitting) a premium allocation model for short-duration insurance contracts is arguably inconsistent with:
- (a) principles-based standard setting. A premium allocation approach is generally regarded as a short-cut method of accounting for short-duration insurance contracts that provides a cost-beneficial measure of the pre-claims liabilities for such contracts. Accordingly, requiring insurers to use such an approach for short-duration insurance contracts introduces a 'bright line' between the accounting requirements for such contracts and other types of insurance contracts; and
  - (b) the objective of the ED. The proposals, if adopted, would prevent an insurer using the proposed comprehensive measurement approach, even if the insurer considered that the comprehensive approach would provide a more relevant and/or reliable measure of the pre-claims liabilities for its short-duration insurance contracts.

In addition, requiring interest to be accreted on insurance contracts that are for periods of approximately one year or less is arguably inconsistent with the view that a premium allocation approach is a simplified or short-cut method for the proposed comprehensive measurement approach.

75. As noted in paragraph 73 of this Agenda paper, the remeasured amount of an onerous short-duration insurance contract would not include an appropriate risk adjustment. This is inconsistent with the comprehensive measurement approach and, consequently, potentially introduces a third measurement approach for insurance contracts.

*Staff views on IASB Question 8*

Staff:

- (a) **agree** with the proposal to include a modified measurement approach for short-duration contracts, but disagree with requiring such an approach because:
- (i) it is inconsistent with principle-based standard setting; and
  - (ii) it would prevent an insurer from applying the proposed comprehensive measurement approach, even when the comprehensive approach would provide more relevant and/or reliable information for users.

Accordingly, staff consider that the replacement Standard for IFRS 4 should permit (rather than require) a premium allocation approach for short-duration insurance contracts;

- (b) **disagree** with the proposal that interest be accreted on short-duration insurance contracts because such an approach is:
- (i) inconsistent with the view that a premium allocation approach is a simplified or short-cut method for measuring particular types of insurance contracts; and
  - (ii) unlikely to significantly affect the amounts reported by insurers in relation to insurance contracts because the discounting period will be short; and
- (c) **disagree** with the proposal that the remeasured amount of onerous short-duration insurance contracts should not include a risk adjustment because it is inconsistent with the proposed comprehensive measurement approach.

**Question 9 – Contract boundary principle (paragraphs 26-29 and BC53-BC66 of ED/2010/8)**

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

*Summary of the relevant proposals*

76. To identify the future cash flows that are expected to arise as the insurer fulfils the obligation, it is necessary to determine whether future premiums (and resulting benefits and claims) arise from existing contracts (included in the liability measurement) or future contracts (not included in the measurement). To achieve this distinction, ED/2010/8 proposes that the boundary of an insurance contract would be the point at which an insurer either:
- (a) is no longer required to provide coverage; or
  - (b) has the right or the practical ability to reassess the risk of the policyholder and, as a result, can set a price that fully reflects that risk.

*Staff analysis*

77. There are a number of arguments in favour of the proposed boundary principle, including:
- (a) it is consistent with notion of insurance risk as defined in the ED. For instance, in circumstances where the contractual terms bind the insurer relatively more so than the policyholder, the contract boundary from the insurer's perspective would be the point at which the insurer has the right or practical ability to change the contractual terms and conditions and potentially the price of the contract to reflect the individual policyholder's risk profile; and
  - (b) taken together, the two criteria would arguably facilitate consistency in determining contract boundaries for both short-duration and long-duration insurance contracts. For instance, the boundaries of most short-duration single premium contracts (such as house and contents insurance contracts) would be determined by the date on which coverage ends. However, for some long-duration contracts, the boundary of the contract is largely determined by the policyholder. For example, in the case of whole life contracts, the insurer is obligated to provide coverage without reconfirmation of risk and at a price that is contractually determined provided the policyholder continues to pay the required premiums.
78. While AASB 1023 and AASB 1038 *Life Insurance Contracts* do not include detailed requirements regarding the boundaries of insurance contracts, staff consider that the current practices among non-health insurers complying with Australian Accounting Standards would be generally consistent with the contract boundary proposals in ED/2010/8. However, if adopted, the contract boundary proposals in ED/2010/8 could have a significant impact on the insurance liabilities reported by health insurers.
79. Most Australian health insurers currently account for their health contracts as short-duration (renewable annually or more frequently) insurance contracts. Nevertheless, most Australian health insurers are currently:
- (a) legally required to accept new policyholders or renewing policyholders;
  - (b) legally required to offer the same price to renewing policyholders and new policyholders previously insured with other insurers on similar terms;
  - (c) restricted in their capacity to change prices to reflect specific risk profiles due to government pricing restrictions; and
  - (d) are subject to 'community rating', whereby those health insurers with policyholder profiles that have a lower claim history are levied to support other health insurers with higher policyholder claims profiles.
80. Accordingly, under the proposals in ED/2010/8 Australian health insurers may be required to treat the boundary of a health insurance contract to be the shorter of the member's estimated:
- (a) period of membership; or
  - (b) life expectancy.

Consequently, health insurers would potentially be required to apply the proposed comprehensive measurement approach to measure both pre-claims and post-claims insurance liabilities. However, it is unclear from the proposals in ED/2010/8 the extent to which requirements outside the explicit terms of an insurance contract (such as legal requirements) form part of the contract terms.

81. From discussions with New Zealand constituents, staff understand that:
- (a) New Zealand's health insurance arrangements do not provide policyholders with the same level of portability as Australian health insurance arrangements;
  - (b) health insurance in New Zealand is subject to less government intervention as compared to the Australian health insurance industry. Consequently, New Zealand health insurers are not as restricted by government imposed pricing restrictions as their Australian counterparts; and
  - (c) most health insurance contracts in New Zealand are underwritten at inception and any re-rating of policyholders is done at the portfolio level rather than at the individual policyholder level.

Nevertheless, there may still be implications of the contract boundary proposals for New Zealand health insurers that are similar to those for Australian health insurers.

***Staff views on IASB Question 9***

Staff **agree** with the proposed boundary principle because:

- (a) it is principle-based;
- (b) it is consistent with notion of insurance risk as defined in the ED; and
- (c) insurers would generally be able to apply it consistently in practice.

**However**, staff considers that the IASB needs to better articulate the impact of contract terms versus the legal environment in a jurisdiction to assist entities such as health insurers to identify contract boundaries consistently.

**Question 10 – Participating features (paragraphs 23, 62-66, BC67-BC75 and BC198-BC203 of ED/2010/8)**

- (a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?
- (b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?
- (c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?
- (d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

*Summary of the relevant proposals*

- 82. Some insurance contracts include terms and conditions which provides policyholders with a right or opportunity to participate in the performance of a specified class of contracts, related assets or both. In some circumstances, the insurer may have some discretion over the amount and/or timing of distributions. However, the discretion may be subject to contractual, regulatory or competitive constraints. In addition, policyholders (and insurers) often expect a certain level of distribution when the performance of the underlying contracts and/or assets has been favourable.
- 83. ED/2010/8 proposes that payments arising from the participating feature should be included in the measurement of insurance contracts in the same way as any other contractual cash outflows (that is, on an expected present value basis plus a risk adjustment, all adjusted for the time value of money). ED/2010/8 also proposes to scope into the replacement Standard for IFRS 4 any financial instrument with a participating feature (as defined in the ED) issued by insurers, even if the financial instrument is not an insurance contract.
- 84. Appendix A of ED/2010/8 defines a discretionary participation feature as:
  - “A contractual right to receive, as a supplement to guaranteed benefits, additional benefits:
  - (a) that are likely to be a significant portion of the total contractual benefits;
  - (b) whose amount or timing is contractually at the discretion of the issuer; and
  - (c) that are contractually based on:

- (i) the performance of a specified pool of insurance contracts or a specified type of insurance contract;
  - (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
  - (iii) the profit or loss of the company, fund or other entity that issues the contract,
- provided that there also exist insurance contracts that provide similar contractual rights to participate in the performance of the same insurance contracts, the same pool of assets or the profit or loss of the same company, fund or other entity.”

85. Consistent with the treatment of an insurance contract:

- (a) the boundary of a financial instrument with a discretionary participation feature would be the point at which the contract holder no longer has a contractual right to receive benefits arising from the discretionary participating feature in that contract; and
- (b) the residual margin for a financial instrument with a discretionary participation feature would be recognised as income in profit or loss over the life of the contract in a systematic way that best reflects the asset management services, as follows:
  - (i) on the basis of the passage of time, but
  - (ii) on the basis of the fair value of assets under management, if that pattern differs significantly from the passage of time.

*Staff analysis*

86. The proposal to include the expected payments arising from a participating feature in the measurement of an insurance contract in the same way as any other contractual cash outflows is consistent with:

- (a) the notion that an insurance contract is a bundle of rights and obligations, including participating benefits; and
- (b) the proposed way in which other parts of an insurance contract would be measured.

87. While financial instruments with discretionary participation features do not transfer significant insurance risk, the expected payments arising from a participating feature would be affected by insurance risk as a consequence of their direct and/or indirect linkages to insurance contracts. Accordingly, including all of an insurer’s financial instruments with discretionary participation features (as defined in the ED) within the scope of the replacement Standard for IFRS 4 would facilitate them being treated consistently with the way in which insurance contracts would be treated. However, some argue that scoping in financial instruments with discretionary participation features that are not insurance contracts simply on the basis that they are issued by insurers is inconsistent with the IASB’s transaction-based approach to standard setting.

88. As noted in paragraph 82 of this Agenda paper, insurers often have some discretion over the amount and/or timing of participating distributions. Accordingly, under the

proposals in the ED, the participating cash flows included in the measurement of an insurance contract would not be limited to those for which a legal or constructive obligation exists. The IASB notes a number of reasons for adopting this approach, including:

- (a) it is consistent with the IASB's overall view that the measurement of insurance contracts should deal in the same way with all cash flows arising from the contracts;
- (b) it can be difficult to determine whether an insurer is paying participating benefits because it believes it is obliged to do so, rather than for some other reason that does not normally justify the recognition of a liability, such as to maintain its competitive position or because it believes it is under some moral pressure. Thus, it could be extremely difficult, and perhaps impossible, to make a reasonable estimate of how much would ultimately be enforceable in the unlikely event that an insurer asserts that its discretion to pay or withhold participating benefits is unfettered; and
- (c) the participating feature may be inversely related to the fixed benefits for the portfolio as a whole. In some scenarios, the fixed benefits will be high and the participating benefits will be low, whereas in other scenarios the fixed benefits will be low and the participating benefits will be high. If the measurement excludes some of the cash flows that would occur in some scenarios, the resulting measurement will be less consistent and understandable and will provide less relevant information for users.

***Staff views on IASB Question 10***

Staff:

- (a) **agree** that the measurement of insurance contracts should include participating benefits on an expected present value basis because:
  - (i) they are a part of the bundle of rights and obligations that form an insurance contract; and
  - (ii) such an approach would facilitate participating benefits being measured on the same basis as other components of an insurance contract would be measured;
- (b) **agree** that financial instruments with discretionary participation features should be within the scope of the IFRS on insurance contracts because:
  - (i) notwithstanding a financial instrument with a discretionary participation feature would not generally transfer significant insurance risk, because of the way ‘discretionary participation feature’ is defined in the ED the cash flows attributable to such features are impacted by insurance risk. Accordingly, including financial instruments with discretionary participation features within the scope of the replacement Standard for IFRS 4 would facilitate such instruments being treated in a manner consistent with the treatment of the related insurance contracts; and
  - (ii) under the proposals in the ED, financial instruments with discretionary participation features would be measured using substantially the same way as they would be measured under other IFRSs, such as IAS 39;
- (c) **agree** with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity for the reasons outlined in paragraph (b)(i) above; and
- (d) **agree** with the modifications proposed in paragraphs 64 and 65 of ED/2010/8 because they would facilitate participating benefits being measured on the same basis as other components of an insurance contract would be measured.

**Question 11 – Definition and scope (paragraphs 2-7, B2-B33 and BC188-BC209 of ED/2010/8)**

- (a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?
- (b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?
- (c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

*Summary of the relevant proposals*

Definition of an insurance contract and related guidance

89. Appendix A of ED/2010/8 proposes that an insurance contract be defined as:
- “A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.”
90. Paragraphs B3-B33 of Appendix B to ED/2010/8 provide proposed guidance in relation to:
- (a) the term ‘uncertain future event’;
  - (b) payments in kind;
  - (c) insurance risk and other risks;
  - (d) examples of insurance contracts;
  - (e) significant insurance risk; and
  - (f) changes in the level of insurance risk.
91. The material in paragraphs B3-B33 of Appendix B of ED/2010/8 is the same or similar to the current guidance in IFRS 4 (paragraphs B2-B30), except for the guidance in relation to:
- (a) fixed-fee service contracts (paragraphs B6, B7 and B18(h) of ED/2010/8);
  - (b) financial guarantees and other similar types of contracts (paragraph B22 of ED/2010/8); and
  - (c) determining significant insurance risk (paragraphs B24-B26 of ED/2010/8). (The notion of significant insurance risk is discussed in more detail in paragraphs 89-92 of this Agenda paper.)
92. Paragraph BC191 of ED/2010/8 discusses two proposed changes from IFRS 4 that would more closely align the replacement Standard for IFRS 4 with relevant US GAAP. Paragraph BC191 states, in part, that:

- “(b) *the role of timing risk.* US GAAP requires the presence of both timing risk and underwriting risk in an insurance contract, whereas IFRS 4 treats contracts that transfer either underwriting risk or timing risk as insurance contracts. In US GAAP, much of the pressure on the notions of underwriting risk and timing risk arises because the accounting for some insurance contracts does not require insurers to discount the expected future cash flows when measuring the insurance liability. However, that pressure is not present in the model proposed in the draft IFRS. Therefore, the Board decided not to propose to require the presence of both timing risk and underwriting risk. However, the draft IFRS introduces a proposal that an insurer should consider the time value of money in assessing whether the additional benefits payable in any scenario (ie if an insured event occurs) are significant (see paragraph B26); and
- (c) *the notion of a loss.* When an insurer assesses whether an insurance contract transfers significant insurance risk, IFRS 4 requires the insurer to consider whether an insured event could require significant additional benefits in any scenario that has commercial substance (see paragraph B23 of IFRS 4 and paragraph B24 of the draft IFRS). The Board understands that practice under US GAAP considers whether the present value of net cash outflows can exceed the present value of premiums in any scenario. The Board proposes to import that as an additional test (see paragraph B25 of the draft IFRS). Although the Board has no specific reason to think that the absence of such a test in IFRS 4 has led to misleading classification of contracts, the inclusion of such a test is consistent with the Board’s understanding of practice under US GAAP.”

#### Scope of the replacement Standard for IFRS 4

93. The proposed scope of the replacement Standard for IFRS 4 is the same as the scope of IFRS 4, except that:
- (a) residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee’s residual value guarantee embedded in a finance lease are explicitly scoped out of the replacement Standard (and within IAS 17 *Leases* and IAS 18 *Revenue*);
  - (b) fixed-fee service contracts that have as their primary purpose the provision of services, but expose the service provider to risk because the level of service depends on an uncertain event are explicitly scoped out of the replacement Standard (and within IAS 18); and
  - (c) the scope exclusion in paragraph 4(d) of IFRS 4 relating to financial guarantees has not been carried over to ED/2010/8, which means that, if adopted, the proposals in ED/2010/8 would apply to financial guarantee contracts (‘credit insurance’) that meet the proposed definition of an insurance contract in the ED.

*Staff analysis*

94. While the proposed changes described in paragraphs BC191(b) and (c) of ED/2010/8 would more closely align the replacement Standard for IFRS 4 with relevant US GAAP, they are unlikely to have a significant impact on accounting practice under Australian and New Zealand GAAP. This is because insurers reporting under Australian and New Zealand standards are required to:
- (a) measure any life insurance liabilities and claims liabilities for general insurance contracts at their expected present value. Accordingly, insurers would be expected to consider the time value of money in assessing whether the additional benefits payable under an insurance contract are significant; and
  - (b) apply a liability adequacy test (LAT) to both life and non-life insurance liabilities, which involves determining the present value of all cash flows under insurance contracts.
95. One respondent to the AASB's ED 201 *Insurance Contracts* (see ED 201 sub 1 in Agenda paper B8.3 to this meeting) notes that the definition of an insurance contract in IFRS 4 has been interpreted differently among some Australian constituents, and that the different interpretations have led to diversity in practice. The respondent notes that some insurance contracts require the insurer to make a payment conditional on an event that would cause a significant loss to the policyholder but does not cause the insurer to pay significant additional benefits in any scenario. The respondent suggests that the contract would not meet the definition of an insurance contract in IFRS 4 because the insurer is not required to pay significant additional benefits in any scenario. The respondent notes, however, that some constituents consider that the contract would meet the definition of an insurance contract in IFRS 4 because the policyholder would suffer a significant loss as a consequence of the insured event (even though the insurer is not required to compensate the policyholder under the contract for this loss).
96. ED/2010/8 proposes that fixed-fee service contracts that have as their primary purpose the provision of services, including:
- (a) maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction; and
  - (b) contracts for car breakdown services in which the provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage;
- be outside of the scope of the replacement Standard for IFRS 4. However, it is relevant to note that fixed-fee service contracts that involve the insurer providing goods or services to compensate the policyholder for insured events would be within the scope of the replacement Standard.
97. Paragraph 9 of IAS 39 defines a financial guarantee contract as:
- “...a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.”

98. As noted in paragraph BC194 of ED/2010/8, a defining feature of both a financial guarantee contract and an insurance contract is that the holder has to have suffered a loss for a payment to be made by the issuer of the contract. In addition, paragraph BC196 of ED/2010/8 notes that:

“For some credit-related contracts, it is not a precondition for payment that the holder has suffered a loss. An example of such a contract is one that requires payments in response to changes in a specified credit rating or credit index. Those contracts are derivatives and do not meet the definition of an insurance contract. The issuer would continue to account for them as derivatives.”

*Staff views on IASB Question 11*

Staff:

- (a) **agree** with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191. In addition, staff consider that, under the proposals in the ED, the term ‘significant insurance risk’ is assessed from the insurer’s perspective, not the policyholder’s perspective (see paragraph 96 of this Agenda paper), because:
- (i) the scope of the ED is limited to accounting for insurance contracts by insurers and reinsurers and does not contemplate the accounting implications of insurance contracts from a policyholders’ perspective; and
  - (ii) paragraph B24 states, in part, that: “Insurance risk is significant, if, and only if, an insured event could **cause an insurer to pay** significant additional benefits in any scenario...” (emphasis added);
- (b) **agree** with the scope exclusions in paragraph 4 of ED/2010/8 because they would facilitate all contracts that expose the issuer to significant insurance risk being accounted for in a consistent manner; and
- (c) **agree** that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the replacement Standard for IFRS 4 in the manner proposed in ED/2010/8 because such an approach would facilitate financial guarantee contracts that expose the issuer to significant insurance risk to be accounted for on the same basis as other types of contracts that expose the issuer to the same type and level of risk.

**Question 12 – Unbundling (paragraphs 8-12 and BC210-BC225 of ED/2010/8)**

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

*Summary of the relevant proposals*

99. Some insurance contracts provide policyholders with more than just insurance coverage. Insurance contracts can, for example, also provide policyholders with goods or services other than insurance coverage (a revenue-generating transaction with a customer) or an investment (a financial instrument). Such components would, if accounted for as if they were separate contracts, be within the scope of another IFRS.
100. ED/2010/8 proposes that if a component of an insurance contract is not closely related to the insurance coverage (in which case the cash flows attributable to the component can be identified separately), the insurer should ‘unbundle’ the component and apply the recognition and measurement requirements in the IFRS that would otherwise have been applied if the component were a separate contract. Under the proposals in the ED, goods or services other than insurance coverage would generally be recognised and measured under the requirements in IAS 18, and investment components would generally be recognised and measured in accordance with the requirements in IFRS 9 or IAS 39.
101. Paragraph 8 of ED/2010/8 identifies the following components of an insurance contract that are generally not closely related to the insurance coverage provided under the contract.
- “(a) an investment component reflecting an account balance that meets both of the following conditions:
    - (i) the account balance is credited with an explicit return (ie it is not an implicit account balance, for example derived by discounting an explicit maturity value at a rate not explicitly stated in the contract); and
    - (ii) the crediting rate for the account balance is based on the investment performance of the underlying investments, namely a specified pool of investments for unit-linked contracts, a notional pool of investments for index-linked contracts or a general account pool of investments for universal life contracts. That crediting rate must pass on to the individual policyholder all investment performance, net of contract fees and assessments. Contracts meeting those criteria can specify conditions under which there may be a minimum guarantee, but not a ceiling, because a ceiling would mean that not all investment performance is passed through to the contract holder.
  - (b) an embedded derivative that is separated from its host contract in accordance with IAS 39 ...

- (c) contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.”

*Staff analysis*

102. As noted in paragraph BC212 of ED/2010/8, unbundling insurance contracts provides a number of benefits, including:
  - (a) insights to users about the non-insurance components of an insurance contract; and
  - (b) consistency in the treatment of non-insurance components of an insurance contract and stand-alone non-insurance contracts that are similar in all other respects.
103. However, the ED does not propose that unbundling be required in all cases. In circumstances where the cash flows attributable to insurance coverage and another component of an insurance contract are interdependent, the ED proposes that the insurer account for the component as a part of the insurance contract. The IASB justifies this approach on the basis that requiring an insurer to separate intertwined cash flows, measure them using a different measurement basis, and track those separate cash flows throughout the life of the contract, would be complex and arguably onerous. Furthermore, the IASB considers that in some cases, an insurer may not be able to objectively allocate cash flows to each of the components (in other words, separating the intertwined cash flows would involve an arbitrary allocation).
104. The IASB contemplated whether to permit unbundling when it is not required (when components are closely related) (see paragraph BC219 of ED/2010/8), but concluded that permitting unbundling when it is not required would be inconsistent with the reasoning for not requiring it in the first place. That is, it is arguably not rational to permit something that would not facilitate the provision of useful to users or could undermine comparability of financial statements between insurers and over time.

***Staff views on IASB Question 12***

Staff:

- (a) **agree** it is appropriate to require insurers to unbundle some components of an insurance contract; and
- (b) **agree** with the proposed criteria for unbundling insurance contracts because:
  - (a) they would facilitate consistency and comparability in financial reporting by ensuring non-insurance components of insurance contracts are treated in a similar manner as financial instruments that are separate contracts but similar in all other respects; and
  - (b) they represent a practical solution that avoids entities being required to report information based on arbitrary allocations of cash flows.

**However**, staff note that the phrases ‘interdependent’ and ‘closely related’ are used somewhat interchangeably in the ED, although the phrases arguably do not have the same meanings. Accordingly, staff consider that the IASB should clarify whether insurers should unbundle insurance contracts on the basis of ‘interdependent’ or ‘closely related’ cash flows. On balance, staff prefer ‘interdependent’ on the basis that it is more consistent (than ‘closely related’) with the IASB’s reasoning for not requiring unbundling when separating cash flows would give rise to reporting outcomes that are not reliable.

**Question 13 – Presentation (paragraphs 69-78 and BC150-BC183 of ED/2010/8)**

- (a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?
- (b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

*Summary of the relevant proposals*

Statement of comprehensive income

105. ED/2010/8 proposes that an insurer present all income and expenses arising from insurance contracts:
- (a) in profit and loss; and
  - (b) in a manner that highlights:
    - (i) the underwriting margin (changes in the risk adjustment and release of the residual margin);
    - (ii) gains and losses at initial recognition, disaggregated either in the statement of comprehensive income or in the notes into:
      - losses on insurance contracts acquired in a portfolio transfer;

- gains on reinsurance contracts bought by a cedant; and
  - losses at initial recognition of an insurance contract
- (iii) non-incremental acquisition costs;
- (iv) experience adjustments (differences between actual cash flows and previous estimates) and changes in estimates (changes in current estimates of cash flows and discount rates, impairment losses on reinsurance assets); and
- (v) interest on insurance contract liabilities (presented or disclosed in a way that highlights its relationship with the investment return on assets backing those liabilities).
106. ED/2010/8 also proposes that an insurer with short-duration insurance contracts include in its statement of comprehensive income (in addition to the applicable line items described in paragraph 105(b) above) the following line items:
- (a) the underwriting margin, disaggregated either in the statement of comprehensive income or in the notes into:
    - (i) premium revenue, determined as the gross release of the pre-claims obligation;
    - (ii) claims incurred;
    - (iii) expenses incurred; and
    - (iv) amortisation of incremental acquisition costs included in the pre-claims obligation; and
  - (b) changes in additional liabilities for onerous contracts.
107. In addition, ED/2010/8 proposes that an insurer present income and expense from:
- (a) unit-linked contracts as a single line item, and not co-mingle them with income and expense from the insurer's other insurance contract liabilities; and
  - (b) the pool of assets underlying unit-linked contracts as a single line item, and not co-mingle them with income or expense from the insurer's other assets.

#### Statement of financial position

108. ED/2010/8 proposes that an insurer present in the statement of financial position:
- (a) each portfolio of insurance contracts as a single item within insurance contract assets or insurance contract liabilities;
  - (b) the pool of assets underlying unit-linked contracts as a single line item, and not co-mingle it with the insurer's other assets; and
  - (c) the portion of the liabilities from unit-linked contracts linked to the pool of assets in (b) as a single line item and not co-mingle it with the insurer's other insurance contract liabilities.

*Staff analysis*

109. ED/2010/8 proposes an insurer adopt a ‘summarised margin’ approach with respect to insurance contracts measured using the proposed comprehensive measurement approach. Under the summarised margin approach, all cash flows associated with insurance contracts are treated as deposits received or repayments to policyholders. Consequently, gross flows such as premiums, benefit payments, claim expenses, claims handling expenses and incremental acquisition costs are not permitted to be presented in the statement of comprehensive income (but are required to be disclosed in the notes, as discussed in paragraph 118(a)(i) of this Agenda paper).
110. The proposed summarised margin approach has a number of advantages over the alternative ‘expanded margin’ approach, including:
- (a) it links clearly with the proposed comprehensive measurement approach; and
  - (b) it is unnecessary under the approach to unbundle deposit receipts from premiums, which can involve arbitrary allocations in some circumstances.
111. The proposed summarised margin approach also has a number of drawbacks, including:
- (a) it is not comparable with the presentation approaches for revenue required of other entities, including fund managers, under IFRSs such as IAS 1 *Presentation of Financial Statements* and IAS 39;
  - (b) it does not present revenue as defined in ED/2010/6 *Revenue from Contracts with Customers* because it depicts as income only part of the total consideration receivable from the policyholder, namely the risk adjustment at initial recognition, and the residual margin;
  - (c) it may be difficult for some entities, particularly diversified financial institutions, to integrate the reported results from insurance activities with the reported results from their other activities; and
  - (d) it is inconsistent with the proposed presentation approach applicable to short-duration insurance contracts measured using a premium allocation approach.
112. The IASB considered the merits of an expanded margin approach and concluded that such an approach would not be appropriate because determining the amount presented in profit or loss could require significant costs (such as those associated with tracking historical information) and could result in amounts in profit or loss that cannot be related in a clear and understandable way to the amounts in the statement of financial position. For instance, in some cases, the income recognised would not be determinable directly, but would need to be imputed by ‘grossing up’ the change in margin by some or all of the claims and expenses.
113. Nevertheless, some argue that gross flow information provides useful information to users regarding:
- (a) the level of a non-life insurer’s activities (because of the general absence of deposit components in non-life insurance contracts) by providing a context for the margin information;
  - (b) insurance contracts that include a significant service element; and

- (c) an insurer's future cash flows and levels of profitability.
114. Under the proposals in the ED, an insurer would not be permitted or required to present any income or expense items arising from insurance contracts in other comprehensive income. The IASB noted that accounting mismatches could arise in respect of insurance liabilities and assets backing those liabilities if an insurer:
- (a) measured financial instruments at amortised cost; and/or
  - (b) presented the gains and losses on investments in equity instruments in other comprehensive income;
- in accordance with IFRS 9.
115. However, the IASB concluded it would not be appropriate to change the accounting for an insurer's assets, other than assets relating to unit-linked and index-linked insurance contracts, because:
- (a) other assets and liabilities of an insurer are outside the scope of the ED;
  - (b) it would be undesirable to create industry-specific requirements for the accounting for assets. To do so would reduce transparency and perpetuate the barriers that impede communication between insurers and users of their financial statements; and
  - (c) it may not be possible to identify which of the insurer's assets are held to back insurance liabilities and which are not.

In addition, any potential accounting mismatches arising from an insurer measuring financial instruments at amortised cost or presenting gains and losses on equity instruments in other comprehensive income under IFRS 9 could be avoided by the insurer electing to measure the relevant assets at fair value through profit or loss. Furthermore, the IASB is considering delaying the effective date of IFRS 9 for insurers if the replacement Standard for IFRS 4 has a mandatory effective date later than 2013, which would allow insurers to reclassify assets currently measured at amortised cost to fair value through profit or loss upon the introduction of the replacement Standard (see paragraphs 134-140 of this Agenda paper).

116. The IASB also concluded that it would not be appropriate to permit or require insurers to present in other comprehensive income changes in the carrying amounts of insurance liabilities backed by financial assets that are measured at amortised cost. This is because such an approach:
- (a) would not eliminate the accounting mismatch from comprehensive income or equity; and
  - (b) is inconsistent with the view that gains and losses on insurance contracts are a core part of an insurer's performance and therefore should be presented in profit or loss.
117. With respect to the presentation of unit-linked insurance contracts and the assets backing such contracts, the IASB concluded that such items, and any income and expenses arising from such items, should be presented separately because such an approach would provide useful information to users of financial statements. Unit-

linked insurance contracts and the assets backing them do not generally expose the insurer to the same risks as other types of insurance contracts and assets. In addition, presenting them (and any income and expenses arising from such items) separately would reflect the nature of these contracts in a transparent way. Such an approach would also distinguish those investment returns that affect the insurer directly from those investment returns that are contractually passed through to policyholders.

**Staff views on IASB Question 13**

- (a) Staff **disagree** with the proposed 'summarised margin' approach as it would not facilitate comparability between the financial statements of entities with insurance activities and other entities. Accordingly, staff **consider** that the proposals in ED/2010/8 should be amended to require an insurer that applies the proposed comprehensive measurement approach to present resulting income and expense items in accordance with an 'expanded margin' approach. Under an expanded margin approach, an insurer would present gross flow information, such as premiums, benefit payments, claim expenses and claims handling expenses, on the face of the financial statements with the underwriting margin information.
- (b) Due to the lack of a generally accepted principle for determining which items should be presented in profit or loss and which items should be presented in other comprehensive income, the proposed approach does not necessarily have a sound conceptual basis. Until that principle is resolved, staff **consider** that an insurer should present all income and expense items arising from insurance contracts in profit or loss.

**Question 14 – Disclosures (paragraphs 79-97, BC242 and BC243 of ED/2010/8)**

- (a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?
- (b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?
- (c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

*Summary of the relevant proposals*

118. ED/2010/8 proposes a set of disclosure principles that aim to assist users of financial statements to understand the amount, timing and uncertainty of cash flows arising from insurance contracts. Under the proposals in the ED, an insurer would provide qualitative and quantitative information about:

- (a) the amounts recognised in the financial statements arising from insurance contracts, including:
  - (i) a reconciliation from the opening to closing aggregate contract balances for:

- insurance contract liabilities;
- insurance contract assets;
- risk adjustments and residual margins in relation to insurance contract liabilities and assets;
- reinsurance assets; and
- risk adjustments and residual margins in relation to reinsurance assets;

showing separately, if applicable, new contracts recognised, premiums received, claims and benefits, expenses, incremental acquisition costs, other cash paid and received, income and expense items presented in the statement of comprehensive income, contracts acquired through portfolio transfers and business combinations, and foreign exchange differences;

(ii) measurement methods and inputs used, including:

- the effect of changes in the inputs used to measure insurance contracts, showing separately the effect of each change that has a material effect on the financial statements; and
- a measurement uncertainty analysis of the inputs that have a material effect on the measurement; and

(b) the nature and extent of risks arising from those contracts, including:

- (i) exposures to and policies for managing insurance risks, and any changes in these from the previous period;
- (ii) information about the effect of the regulatory frameworks in which the insurer operates;
- (iii) information about insurance risk;
- (iv) sensitivity to insurance risk in relation to its effect on profit or loss and equity;
- (v) concentrations of insurance risk;
- (vi) claims development information (for contracts other than those for which uncertainty about the amount and timing of claims payments is typically resolved within one year. However, the ED proposes that an insurer should separately disclose the claims and expenses incurred during the period in relation to such contracts); and
- (vii) exposures to and concentrations of risks other than insurance risks.

119. For short-duration contracts measured using a premium allocation approach, the ED proposes that an insurer disclose the reconciliation for contract balances separately for:

- (a) pre-claims liabilities;
- (b) additional liabilities for onerous insurance contracts; and
- (c) claims liabilities.

*Staff analysis*

120. The disclosure proposals in ED/2010/8 are based on the current disclosure requirements in IFRS 4, including the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* that are incorporated in IFRS 4 by cross-reference. The main changes proposed from the current disclosure requirements include:
- (a) a principle on the level of aggregation. This is consistent with other current proposals by the IASB (for instance, ED/2010/3 *Defined Benefit Plans – Proposed amendments to IAS 19*) and would require an insurer to use the most useful disaggregation level to satisfy the disclosure principle;
  - (b) information about the amounts recognised, including:
    - (i) reconciliations of changes in the contract balances, including disclosures about changes in the risk adjustment;
    - (ii) explanations of the methods, inputs and processes used in the measurement;
    - (iii) the translation of risk adjustments into a confidence level for disclosure, even if the insurer had not used that technique to determine the risk adjustment; and
    - (iv) measurement uncertainty analyses; and
  - (c) information about the effect of the regulatory framework in which the insurer operates, which is consistent with the IASB's proposals in ED/2010/3 in respect of post-employment benefits.

***Staff views on IASB Question 14***

Staff:

- (a) **agree** with the proposed disclosure principles because they would facilitate an insurer disclosing useful information about the amounts recognised in its financial statements and the risks to which it is exposed in relation to insurance contracts;
- (b) **agree** that the proposed disclosure requirements would meet the proposed objective. **However**, staff recommend that the IASB seek to align the disclosure requirements in the replacement Standard for IFRS 4 in relation to sensitivity analyses with the corresponding disclosure principles in the revised versions of IAS 19 *Employee Benefits* for defined benefit obligations and IFRS 7 for Level 3 fair value measurements (**Please note**: staff do not support the IASB's most recent proposals regarding the disclosures of ranges of amounts for Level 3 fair value measurements. However, if the IASB's recent proposals in respect of IFRS 7 were adopted, we would recommend they be consistent with similar disclosures in respect of insurance liabilities); and
- (c) **have not identified** any additional disclosures that would be useful.

**Question 15 – Unit-linked contracts (paragraphs 8(a)(i), 71 and 78, Appendix C and paragraphs BC153-BC155 and BC184-BC187 of ED/2010/8)**

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

*Summary of the relevant proposals*

121. Appendix A of ED/2010/8 defines a unit-linked contract as:

“A contract for which some or all of the benefits are determined by the price of units in an internal or external investment fund (ie a specified pool of assets held by the insurer or a third party and operated in a manner similar to a mutual fund). In some jurisdictions referred to as a variable contract.”

122. For unit-linked contracts, the ED proposes that, for assets for which existing requirements result in an accounting mismatch, an insurer should recognise the underlying assets and measure them at fair value through profit or loss. With respect to those assets, this proposal would require consequential amendments to:

- (a) IAS 32 *Financial Instruments: Presentation* and IFRS 9 to address shares issued by the insurer; and
- (b) IAS 16 *Property, Plant and Equipment* to address property occupied by the insurer.

123. In addition:

- (a) the proposals in the ED on unbundling are relevant for unit-linked contracts (see paragraphs 99-104 of this Agenda paper); and
- (b) the ED proposes presentation requirements for unit-linked contracts and related assets (see paragraph 107 of this Agenda paper).

*Staff analysis*

124. The IASB’s main justification for proposing to amend IAS 32, IFRS 9 and IAS 16 is to avoid, to the extent feasible, insurer’s recognising accounting mismatches. Currently:

- (a) an insurer’s investments in its own shares are not permitted to be recognised as assets of the insurer under IAS 32; and
- (b) property occupied by an insurer is accounted for under IAS 16, which requires fair value remeasurement changes to be recognised in other comprehensive income (rather than in profit or loss).

However, the ED proposes that income and expenses from unit-linked contracts be presented in profit or loss, even as they relate to investments in the entity’s own shares or investment properties the insurer occupies.

125. The IASB concluded that accounting mismatches make an insurer’s financial statements less relevant to users and less understandable, resulting in a less faithful representation of the insurer’s financial position and financial performance. The IASB

also concluded that, to improve the comparability of financial statements between insurers and over time, insurers should be required (rather than permitted) to apply the proposed amendments to IAS 32, IFRS 9 and IAS 16. However, the ED does not propose to introduce a requirement for insurers to measure all financial assets underlying unit-linked contracts at fair value through profit or loss, if that would not otherwise be required by IFRS 9 or IAS 39.

126. While the proposals in the ED would potentially eliminate many accounting mismatches that currently arise under IFRS 4, it is relevant to note that accounting mismatches would still arise in respect of investments in subsidiaries that hold material internally generated intangible assets and/or internally generated goodwill under the current consolidation requirements.

**Staff views on IASB Question 15**

Staff **agree** with the proposals on unit-linked contracts, primarily because they would reduce the potential for significant accounting mismatches to arise.

**Question 16 – Reinsurance (paragraphs 43-46 and BC230-BC241 of ED/2010/8)**

- (a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?
- (b) Do you have any other comments on the reinsurance proposals?

*Summary of the relevant proposals*

127. ED/2010/8 proposes that a cedant (insurer) and the reinsurer measure their contractual rights and obligations on the same basis. Accordingly, under the proposals in the ED, a cedant would measure a reinsurance contract at initial recognition as the sum of:
- (a) the present value of the fulfilment cash flows (the expected present value of the cedant's future cash inflows *plus* an appropriate risk adjustment *less* the expected present value of the cedant's future cash outflows); and
- (b) a residual margin.
128. In estimating the present value of the fulfilment cash flows under a reinsurance contract, the cedant would estimate the present value of the fulfilment cash flows for the reinsurance contract in the same manner as the corresponding part of the present value of the fulfilment cash flows for the underlying insurance contract or contracts, after remeasuring the underlying insurance contract(s) on initial recognition of the reinsurance contract. In addition, the cedant would consider the risk of non-performance by the reinsurer on an expected value basis when estimating the present value of the fulfilment cash flows, and remeasure the present value of the fulfilment cash flows for changes in the risk of non-performance by the reinsurer.

129. Consistent with the proposals with respect to residual margins for insurance contracts, any residual margin in respect of a reinsurance contract cannot be 'negative'. In a reinsurance context, a negative residual margin would arise when the expected present value of the fulfilment cash inflows (that is, reinsurance receipts for claims under the insurance contracts) plus an appropriate risk adjustment is greater than the expected present value of future cash outflows (the present value of the premiums ceded to the reinsurer). If a negative residual margin is recognised in respect of a reinsurance contract, the cedant (insurer) would recognise that amount as a gain at initial recognition of the reinsurance contract.
130. If a 'positive' residual margin arises in respect of a reinsurance contract (that is, the expected present value of the fulfilment cash inflows plus an appropriate risk adjustment is less than the expected present value of future cash outflows), the cedant would:
- (a) establish that amount as the residual margin at initial measurement; and
  - (b) release the residual margin to profit or loss over the coverage period in a systematic manner based on the passage of time, unless the pattern of claims and benefits makes another pattern more appropriate.

*Staff analysis*

131. The IASB notes that the main benefit of proposing a single method for all types of insurance contracts, including reinsurance contracts (with some modification for some short-duration contracts), is that this would provide users with information prepared consistently for these various types. However, the proposal that a 'negative' residual margin be recognised as a gain at the inception of an insurance contract is arguably inconsistent with the proposed treatment of an equivalent margin on a direct insurance contract. Accordingly, under the proposals in the ED, insurance and reinsurance contracts would be treated differently, which would potentially undermine any benefits from requiring them to otherwise be measured on the same basis.
132. Paragraph BC236 of ED/2010/8 outlines the IASB's main reasons for proposing that 'negative' residual margins in relation to reinsurance contracts be recognised as a gain at inception. Paragraph BC236 states that:
- “The amount paid by the cedant would typically exceed the expected present value of cash flows generated by the reinsurance contracts plus the risk adjustment. Thus, a positive residual margin would typically arise at the initial recognition of a reinsurance contract. The Board considered whether the residual margin in the reinsurance contract could be negative if, in rare cases, the amount paid by the cedant is less than the expected present value of cash flows plus the risk adjustment. The Board noted that the most likely causes of such a negative difference would be:
- (a) an overstatement of the underlying direct insurance contract(s). A cedant would deal with this by reviewing the measurement of the direct contract(s).
  - (b) favourable pricing by the reinsurer, for example as a result of diversification benefits. The Board concluded that the recognition of a

gain would be appropriate in such cases. This is because doing so is consistent with the Board's conclusion that the residual margin for the underlying contract should not be negative (although for the underlying contract the consequence is the immediate recognition of a loss, rather than the immediate recognition of a gain)."

133. The discussion in paragraph BC236 raises a number of issues, including:
- (a) in some jurisdictions, such as Australia and New Zealand, reinsurance arrangements often give rise to a 'negative difference' on the inception of reinsurance contracts. This is because some reinsurers regard Australia and New Zealand as providing good geographic diversification in the context of other jurisdictions they are exposed to (such as the US and Europe) and, therefore, they are willing to offer relatively attractive reinsurance arrangements; and
  - (b) under the proposals in the ED, insurers are not permitted to reflect diversification benefits across their portfolios in their accounting for insurance contracts. However, insurers would be required to reflect the effects of the diversification benefits experienced by reinsurers in their accounting for the reinsurance arrangements.

*Staff views on IASB Question 16*

Staff:

- (a) **agree** with the proposal for an expected loss model for reinsurance assets, primarily because it is consistent with the proposed measurement approach for insurance liabilities (expected present value of the future cash flows) and therefore is less likely to give rise to asymmetrical accounting treatments; and
- (b) **do not agree** with insurers being required to recognise a gain on inception of a reinsurance contract. Such an approach is inconsistent with the IASB's reasoning for proposing that a residual margin be recognised to avoid the recognition of 'day-one' gains. In addition, we do not consider the IASB's reasons outlined in paragraph BC236 are sufficient to justify the proposed approach, particular the observations regarding diversification benefits. Contrary to the approach in ED/2010/8, staff consider that the logic underlying the proposed approach applicable to residual margins arising from direct insurance contracts be extended to residual margins arising from reinsurance arrangements. Accordingly:
  - (i) 'positive' residual margins (losses at inception on reinsurance arrangements) should be recognised as losses in the profit or loss on inception of the reinsurance contract; and
  - (ii) 'negative' residual margins (gains at inception on reinsurance arrangements) should be released to profit or loss over the coverage period in a systematic manner based on the passage of time, unless the pattern of claims and benefits makes another pattern more appropriate.

In addition, staff note that paragraph 50 of ED/2010/8, which appears to deal with the subsequent treatment of all residual margins (those related to direct and reinsurance contracts), states that "An insurer shall recognise the residual margin determined at initial recognition as income in profit or loss...". However, a residual margin that arises in a reinsurance contract is in the nature of a loss. Accordingly, staff recommend that, if the IASB adopts the proposals in respect of residual margins, paragraph 50 be amended to require the residual margin to be recognised as income **or expense** in profit or loss.

**Question 17 – Transition and effective date (paragraphs 98-102 and BC244-BC257 of ED/2010/8)**

- (a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?
- (b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?
- (c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?
- (d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

*Summary of the relevant proposals*

134. ED/2010/8 proposes that, at the beginning of the earliest period in which the proposals in the ED are applied, an insurer should (with a corresponding adjustment to retained earnings):
- (a) measure each portfolio of insurance contracts at the present value of the fulfilment cash flows. Accordingly, for insurance contracts to which the proposed transitional provisions would apply, the measurement, both at transition and subsequently, would not include a residual margin;
  - (b) derecognise any existing balances of deferred acquisition costs; and
  - (c) derecognise any intangible assets arising from insurance contracts assumed in previously recognised business combinations. That adjustment, however, would not affect intangible assets, such as customer relationships and customer lists, which relate to possible future contracts.

In addition, on first application an insurer would be exempted from disclosing some information about claims development in prior (comparative) periods.

135. ED/2010/8 also notes that the IASB:
- (a) is unlikely to prohibit early adoption of the replacement Standard for IFRS 4; and
  - (b) will consider delaying the effective date of IFRS 9 for insurers if the replacement Standard has a mandatory effective date later than 1 January 2013.

*Staff analysis*

136. The IASB's transition proposals arguably reflect the view that different jurisdictions are at different points along the 'road' to the proposals in ED/2010/8, particularly in relation to residual margins. The IASB notes that for some insurers, determining the remaining amount of any residual margin may be problematic. The IASB also notes that:

- (a) retrospective application of the proposals in respect of residual margins would be potentially burdensome and costly for many insurers, as well as potentially subject to bias through the use of hindsight; and
  - (b) IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* potentially prohibits retrospective application in the types of circumstances described in (a) above.
137. The IASB considered the merits of an approach that would have determined the residual margin on transition to the replacement Standard for IFRS 4 as the difference (but not less than zero) between:
- (a) the carrying amount of the insurance liability immediately before transition; and
  - (b) the present value of the fulfilment cash flows at that date.
- That approach would have had the advantage of maintaining some continuity with previously reported profit or loss, without imposing significant additional costs. However, the IASB rejected such an approach because the resulting residual margins would not have been comparable with residual margins for subsequent contracts, and would have depended significantly on the pattern of income recognition under previous accounting models, which are not uniform across jurisdictions.
138. Presently, life insurers in Australia and New Zealand have claims liabilities that include unearned profits ('planned margins of revenues over expenses') that would be recognised in profit or loss over future reporting periods as the remaining coverage periods of the underlying contracts expire. Under the IASB's proposals, Australian and New Zealand life insurers would recognise the balance of any planned margins of revenues over expenses from contracts currently in force in retained earnings on transition and would not be permitted to 'recycle' the planned margins through profit or loss going forward.
139. Because IFRS 4 permits an insurer to change accounting policies for insurance contracts if the insurer shows that the change results in more relevant or reliable information, it is unlikely to be feasible for the IASB to prohibit early adoption of the replacement Standard for IFRS 4.
140. IFRS 4 permits, on transition to the Standard, an insurer to redesignate its financial assets as available for sale only to avoid an accounting mismatch that arises when the insurer's financial assets are measured at fair value and its insurance liabilities are measured on a non-prospective measurement basis (which IFRS 4 allows). The IASB notes that insurers applying IFRS 9 (which removes the available for sale classification) before the new IFRS on insurance contracts may wish to reclassify some of their financial assets, where allowed, at amortised cost rather than at fair value through profit or loss in order to continue to avoid the accounting mismatch. However, because ED/2010/8 proposes that an insurer measure its insurance liabilities on a prospective basis with all remeasurements recognised in profit or loss, accounting mismatches would arise if an insurer continued to measure its financial assets at amortised cost. To avoid that outcome, ED/2010/8 proposes that, on adoption of the replacement Standard for IFRS 4, an insurer would be permitted to use the fair value option to redesignate its financial assets by measuring them at fair value through profit or loss.

*Staff views on IASB Question 17*

Staff:

- (a) **agree** with the proposed transitional requirements except for the proposal to eliminate any existing residual margins against opening retained earnings upon transition. This is on the basis that:
- (i) insurers that are currently accounting for insurance contracts on a similar basis to the proposals in the ED could apply the proposed requirements retrospectively and the IASB's 'normal' position under IAS 8 is that retrospective application should be performed, subject to impracticability; and
  - (ii) would potentially reduce the comparability of the financial statements of insurers that were reporting under IFRS 4 prior to transition and insurers that establish themselves after the transition to the new reporting requirements.

Accordingly, staff consider that entities should be permitted to assess for themselves whether retrospective application of the replacement Standard for IFRS 4 is impracticable;

- (b) **do not agree** with the FASB's tentative decision on the treatment of the composite margin on transition for the reasons discussed in (a) above. The FASB proposes that the composite margin would be set equal to the risk adjustment determined under the IASB's proposals. In addition, the risk adjustment would be released to profit or loss under the FASB's proposed approach (systematically over the coverage period and claims handling period);
- (c) **agree** that insurers should:
- (i) not face two rounds of major changes in a short period; and
  - (ii) be able to avail themselves of the measurement choices under IFRS 9 to avoid any potential accounting mismatches that might arise as a consequence of transitioning from their domestic GAAP to the replacement Standard for IFRS 4.

To this end, staff support the proposal to delay the effective date of IFRS 9 for insurers if the replacement Standard for IFRS 4 has a mandatory effective date later than 2013; and

- (d) **consider** that Australian and New Zealand insurers are relatively well-placed to adopt the proposed requirements.

**Question 18 – Other comments**

Do you have any other comments on the proposals in the exposure draft?

***Staff views on IASB Question 18***

Staff **consider** that the discount rate proposals in ED/2010/8 serve to highlight the inconsistencies that currently exist across IFRSs with respect to the determination of discount rates, particularly for liabilities that are similar in nature to insurance liabilities, such as defined benefit obligations. Accordingly, staff consider that the IASB should commence a comprehensive project on discount rates once the current suite of high priority projects has been completed.

**Question 19 – Benefits and costs (paragraphs BC258-BC263 of ED/2010/8)**

Do you agree with the Board's assessment of the benefits and costs of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefits and costs associated with the proposals.

*Staff analysis*

141. In evaluating the potential costs and benefits of the ED, the IASB notes that:

- (a) the proposals in the ED would improve financial reporting by insurers at a global level because insurers would recognise, measure and present life and non-life insurance contracts and direct insurance and reinsurance contracts on a consistent and comparable basis (with some modifications for the pre-claims liabilities in relation to particular short-duration insurance contracts);
- (b) the proposals in the ED would improve the understandability of insurers' financial statements at a global level. In contrast, because a range of insurance accounting practices can be applied under IFRS 4, users of an insurer's financial statements may be currently unable to compare those financial statements with those of another insurer that writes the same insurance business. Furthermore, under IFRS 4, an insurer's financial statements could include internal inconsistencies if different recognition, measurement or presentation principles are applied to different types of insurance contracts;
- (c) the building blocks approach, including the separate identification of a risk adjustment, would result in a more faithful representation of an insurance contract. Because the measurement basis is a current measurement, the proposals in ED/2010/8 would resolve many of the accounting mismatches that can arise at present in an insurer's financial statements; and
- (d) some insurers might need to make systems and operational changes to comply with the proposals in ED/2010/8. The costs involved to make systems changes to collect the information required by the proposals would be incurred primarily

during the transition from IFRS 4. Depending on the internal processes that an insurer uses in managing its insurance businesses, the insurer may incur additional costs on an ongoing basis to change operational processes as well. Although an insurer will incur costs to establish and maintain the systems and processes necessary to make explicit cash flow estimates and to manage risk adjustments, this will result in the provision to users of better information about an insurer's insurance contracts, and it might also improve the quality of the information available to internal managers for managing their businesses.

*Staff views on Question 19*

Staff **agree** with the IASB's assessment of the benefits and costs of the proposed accounting for insurance contracts. Staff consider that, overall, the proposals would lead to improvements in the relevance and reliability of the information reported by insurers at a global level that are cost-beneficial.

Staff consider it **would not be feasible** to reliably determine the likely quantum of benefits and costs associated with the proposals.

## Appendix A – A Copy of the Draft Minutes of the FRSB’s Meeting on 26 August 2010 (Insurance Contracts)

### B5 Insurance

#### **B5.1 Receive education session: Memo from Dean Ardern and Angus Thomson: Insurance Contracts**

#### **B5.2 Note outline of IASB ED/2010/8 *Insurance Contracts* compared with AASB 1023 *General Insurance Contracts*/Appendix D of NZ IFRS 4 and AASB 1038 *Life Insurance Contracts*/Appendix C of NZ IFRS 4**

#### **B5.3 Consider memo from Clive Brodie: FRSB’s approach to IASB’s Insurance Project**

#### **B5.4 Note New Zealand Request for Comment on IASB Exposure Draft ED/2010/8 *Insurance Contracts***

#### **B5.5 Note IASB Exposure Draft ED/2010/8 *Insurance Contracts***

The FRSB received an education session on the IASB’s Exposure Draft. The FRSB noted the following:

- The FRSB agreed with the preliminary comments on the IASB’s proposals outlined in agenda paper B5.2 Outline of IASB ED/2010/8 *Insurance Contracts* compared with AASB 1023 *General Insurance Contracts*/Appendix D of NZ IFRS 4 and AASB 1038 *Life Insurance Contracts*/Appendix C of NZ IFRS 4.
- Scope: The IASB’s proposals will affect not only profit oriented insurers but also state or government insurers and other public benefit entities such as New Zealand Treasury and the Accident Compensation Corporation (ACC).
- Unbundling of contracts: The FRSB supports unbundling components of an insurance contract that are not closely related to insurance coverage.
- Initial measurement: The approach to initial contract measurement is an acceptable pragmatic approach that avoids recognition of day one gains.
- Residual margin unit of account: The IASB is proposing grouping residual margins based on the date of contract inception and the coverage period. It may be more practicable to group residual margins based on the remaining term and the nature of the underlying contract i.e. to group residual margins, the remaining period over which the margin is to be recognised must be the same and the underlying contracts must have similar terms and conditions.
- Contract boundary: The impact of the proposals on non-contractual insurance needs to be considered. For example, in the case of state/government insurers providing insurance cover under statute such as New Zealand Accident Compensation Corporation (ACC). The IASB plans to issue a final standard within a short time frame. Ideally any modifications required for public benefit entities would be finalised within the same timeframe, however, this is not entirely necessary.

- Discount rates: The IASB is proposing more specific requirements on which discount rates must be used. It is unclear whether the proposals reflect the IASB's preferred approach or latest thinking on discount rates or simply the preferred approach in the case of insurance liabilities. The FRSB would recommend that the IASB review all the guidance on discount rates within IFRSs, determine the appropriate discount rates to use and whether there is opportunity to standardise the guidance to improve consistency across all IFRSs. The current lack of consistency across various IFRSs causes concern for preparers, particularly large preparers such as New Zealand Treasury.
- Risk adjustments - maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate cash flows exceed those expected: Measurement at an exit price assumes the existence of a market where a market in fact does not exist. This immediately creates difficulty for preparers (particularly insurers providing insurance under statute).
- Risk adjustments - unit of account: The IASB is proposing not to allow cross-portfolio diversification. The FRSB recommends that the unit of account reflect the manner in which management operates the business.
- Initial outwards reinsurance contract measurement: The IASB is proposing that gains could arise on initial recognition of reinsurance contracts but proposes that none can arise on initial recognition of other insurance contracts. The FRSB considered that the approach to insurance contracts ought to be consistent regardless of who the insured is i.e. the insured being an insurer does not justify a different approach. Ideally the IASB should maintain consistency between standards and even more so within the same standard.
- Income statement presentation: The proposed presentation is very different from the current method of presentation. Presenting items on a net basis may reduce the amount of useful information for users. In particular, information about the volume of business may be lost. If the IASB proceeds with the proposed presentation an insurer should at least be permitted to disclose gross information in the notes to the financial statements. Also, presenting information on a net basis will cause difficulties when having to consolidate an insurer's results into a group that includes non-insurers.
- Other – related assets: The IASB is proposing that assets backing unit-linked contracts for which exiting requirements result in an accounting mismatch should be measured at fair value through profit or loss. This is a positive step for insurance accounting.
- Transition: The proposal to require that, on adoption of the proposed standard, all unearned income be transferred to retained earnings is too punitive as it would prevent recognition of profit on existing contracts. Instead the IASB should allow more of a prospective change in policy.
- The FRSB largely supports the IASB's proposals and the AASB-FRSB comment letter should acknowledge general support for the IASB's proposals and that the proposals effectively address a number of insurance accounting issues faced in New Zealand and Australia.

The FRSB considered its approach to the IASB's insurance project and agreed the following:

- The FRSB would support the AASB's comment letter on the IASB's Exposure Draft rather than drafting its own.
- The FRSB Insurance Working Group and the AASB Insurance Project Advisory Panel would be combined into a joint working group. The FRSB would recommend the members of the FRSB's Insurance Working Group (as well as other individuals recommended by the members of the working group and/or the FRSB) for the joint working group.
- The FRSB would invite individuals from the New Zealand insurance industry to participate in the AASB insurance roundtable.

The FRSB noted that the draft AASB-FRSB comment letter on the IASB's Exposure Draft would be considered at the joint AASB-FRSB meeting in October 2010.

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**FRSB Resolution(s)**

**FRSB Resolution 1:** The FRSB agreed that it would support the AASB's comment letter on IASB Exposure Draft ED/2010/8 *Insurance contracts* rather than draft its own.

**FRSB Resolution 2:** The FRSB agreed the FRSB's Insurance Working Group (IWG) would be combined with the AASB's Insurance Advisory Panel into a joint New Zealand/Australian panel and that the members of the FRSB's IWG (as well as any other suitable candidates recommended by the members of the IWG and/or the FRSB) would be recommended for membership of the joint advisory panel.

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**Action Point(s)**

**Action Point 1:** *Clive Brodie to collect details of individuals recommended for the joint AASB-FRSB Insurance Advisory Panel and provide the details to Angus Thomson and Dean Ardern.*