IFRS 4 Exposure Draft – IAI comments to IASB

LIAG and AGAS - CILA

November 29, 2013

Agenda

Background

Adjusting the contractual service margin

Contracts with links

Interest expense in profit and loss

Presentation of revenue and expenses

Transition

Impact and drafting

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Background

- IFRS 4 published in 2004 as in interim standard
- Discussion paper "Preliminary views on insurance contracts" published in May 2007
- Exposure draft "Insurance contracts" published in July 2010
- Current exposure draft published in June 2013
- Comments invited by October 25, 2013
- Drafting group of IAI prepared comments

Current fulfillment value

Contractual Service Margin	Remaining margin (reported over life of contract)
Risk adjustment	An adjustment for the uncertainty about the amount of future cash flows
Discount	An adjustment that uses an interest rate to convert future cash flows into current amounts
Expected value of cash flows	The amounts the insurer expects to collect from premiums and pay out for claims, benefits and expenses, estimated using up-to-date information

Building blocks

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Contractual Service Margin (CSM)

- A margin to eliminate any gain at inception of the contract
- CSM can be thought of as the present value of future profits
- Initially estimated and amortized at a portfolio level
  - "Portfolio" means polices with similar risk characteristics and managed together
- Calculated at initial recognition and amortized in subsequent valuations
- Cannot be negative, as a loss must be recognized immediately through the income statement

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Adjusting the CSM – key proposals

- CSM to be unlocked for changes to non-economic assumptions
  - Subject to CSM remaining positive
  - Change beyond available CSM will flow into income statement immediately
- Experience variances to flow through the income statement
- Economic assumptions to remain locked

Adjusting the CSM – IAI comments

- Agree with the proposed unlocking mechanism
- Comments on impact of economic assumption change provided separately
- In the event that CSM is zero
  - Suggestion that in case of reduction in fulfilment cash flows, past losses be adjusted first before creating a CSM

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Contracts with links

- Liabilities that are “linked” to assets
  - Hold underlying items such as specified assets and liabilities, an underlying pool of insurance contracts, or if the underlying item specified in the contract is the assets and liabilities of the entity as a whole; and
  - Specifies a link between the payments to the policyholder and the returns on those underlying items.
- Goal is to eliminate accounting mismatches where economic mismatches are not possible
  - Applies to Par, unit linked, universal life type contracts

Contracts with links

- Decompose the cash flows into possibly 3 parts
  - Variable cash flows that depend on the underlying items
    - Measured by reference to their carrying value
  - Indirectly varying cash flows (usually options and guarantees)
    - Recognized in profit or loss
  - Fixed independent cash flows
    - Measured like the standard cash flows with parts split between P&L, OCI and CSM

Contracts with links

- Method of decomposition would be arbitrary
  - Implies that recognition in P&L or OCI would also be arbitrary
- The distinction between a fixed cash flow and one that varies with underlying items may not be clear
  - The extent to which future bonus rates may be varied could be a matter a judgement
- Potential inconsistency in measuring cost of embedded derivatives

Contracts with links – comments of IAI

- Where the mirroring is significant
  - Value all elements by reference to a valuation rate that reflects the carrying value of the backing assets
    - Due allowance for expected reinvestment rates
- This would still leave a mismatch where
  - Assets are categorised as HTM
    - Changes in value may be split between OCI and P&L: unrealised gains would reside in the former and realised gains would reside in the latter

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Interest expense in profit and loss

- Other comprehensive income (OCI)
  - A way to remove “X” from impacting the income statement but still have it show up in the balance sheet and statement of comprehensive income
  - “X” could be:
    - Spurious or short term volatility
    - An accounting mismatch
    - Something that is not part of the core underlying earnings
    - Something a company wishes was not part of the core underlying earnings

Proposal in ED

- The following should be moved to OCI
  - Changes in the insurance liability arising from changes in the discount rate
  - Changes in the insurance liability arising from changes in interest sensitive cash flow assumptions (such as minimum crediting rates and lapse assumptions)
  - All these changes regardless of whether or not they reduce accounting mismatches – it is NOT optional
  - Once insurance contract is derecognized, any remaining OCI amounts should flow back through the P&L

Proposal in ED – key issues

- Potential mismatches given permitted asset classification in IFRS 9
- Does not highlight to reader the consequences of deliberate mismatches in assets and liabilities
- Difficult to interpret the components of change in value going through OCI
  - Both catch up effect of the past and future value changes
- Potential for manipulation of profits through asset classification

Proposal in ED – IAI suggestions

- Mandate changes to be taken to P&L where asset classification is "Fair value through P&L"
- Alternatively, allow the option of taking the changes through P&L or OCI
- This could also potentially eliminate the challenges faced for contracts with links

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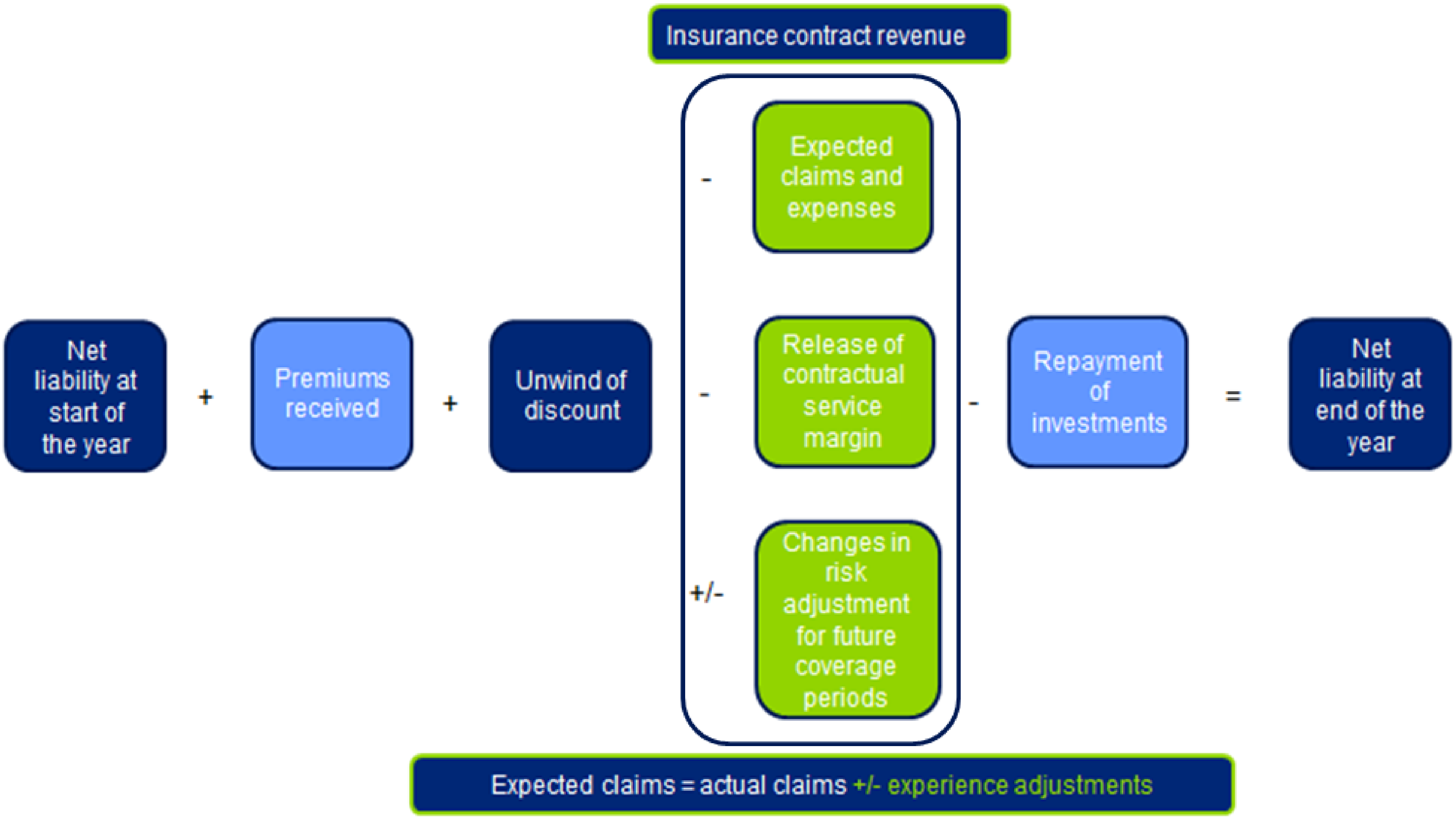
Presentation of Insurance Revenue



Linking liability movements to revenue and expense

Presentation of revenue and expenses

- Revenue is formula driven based on
  - Release of contractual service margin
  - Period expected cash outflows
  - Acquisition cost period allocation
  - Risk adjustment change
- Only those outflows relating to the coverage period are recognized as revenue
- Outflows representing repayments of deposit components (“returnable amounts”) are excluded.
- Net experience variances, changes in CSM and the changes in the risk adjustment recognized as revenue

Presentation of revenue and expenses - observations

- Significant departure from current representation
- However, consistent with concept of revenue in other industries
- Complex to compute
- Stripping out investment component appears to be forced unbundling
- Determination of investment component itself is subjective

- IAI comments
  - The complexity may not be seen to add sufficient value and a gross premium approach may be more useful

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Transition – provisions of the ED

- Compute the CSM at inception on locked in economic assumptions
  - Simplified approaches to determining discount rates at inception permitted
- Compute current liability based on current discount rates
- Reflect catch up of the change in estimates in Equity or cumulative OCI as appropriate

Transition – Challenges

- Re-creating assumptions that would have applied at the time of inception of the contracts
  - Separately for each cohort
- Discontinuity in profit streams between the old and new reporting regimes
  - Since catch up is reflected directly in the shareholder equity

- IAI suggestion
  - Permit transition such that CSM on date of transition is set such that no surplus arises on transition

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Impact and drafting – comments of IAI

- There is a significant amount of complexity in the proposed standard that would result in a high cost of implementation
- Participating business treatment is not adequately covered in the ED
  - Treatment of estate does not seem to be adequately covered

Thank you