IASC Insurance ED Submission Insights Briefing

Brendan Counsel, Michael Dermody & Grant Robinson

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Insurance ED Submission

- Overview - Grant
  - Submission Development
  - Insurance ED
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- Adjusting the Contractual Service Margin (CSM) – Q1 - Grant
- Other Comprehensive Income (OCI) – Q4 - Brendon
- Mirroring for cash flows linked to assets – Q2 -Brendon
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- Likely Effects – costs vs benefits – Q6 - Michael
- Clarity of Drafting – Q7 – Michael
- Future Developments - Grant

Overview - Submission Development

- IFRS Insurance Insights Presentation - April 2013:
  - Refresher and update on developments since the 2010 ED;
  - Overview of the key changes, IASB rationale and emerging issues;
  - Nature of IASB decision making and the submission process;
- Participated in joint IASB / AASB Insurance ED Roundtables & had discussions with IASB staff;
- AASB staff participated in our meetings, shared insights & perspectives, invaluable help, especially in framing OCI , &alignment with the AASB;
- Joint meeting & discussions with the AALC;
- Meet separately with LIWMPC and GIPC in September to discuss the key issues & the proposed draft response;
- Brent Walker represented the Health Practise Committee, whose key issue was does the ED contract boundary wording enable Australian Health Insurance contracts to be treated as short term under the Standard;
- Participated in discussions on the development of the IAA submission
- Contact and discussions with others developing submissions, including ABI:
- Public Policy Committee considered & approved the Submission in October.

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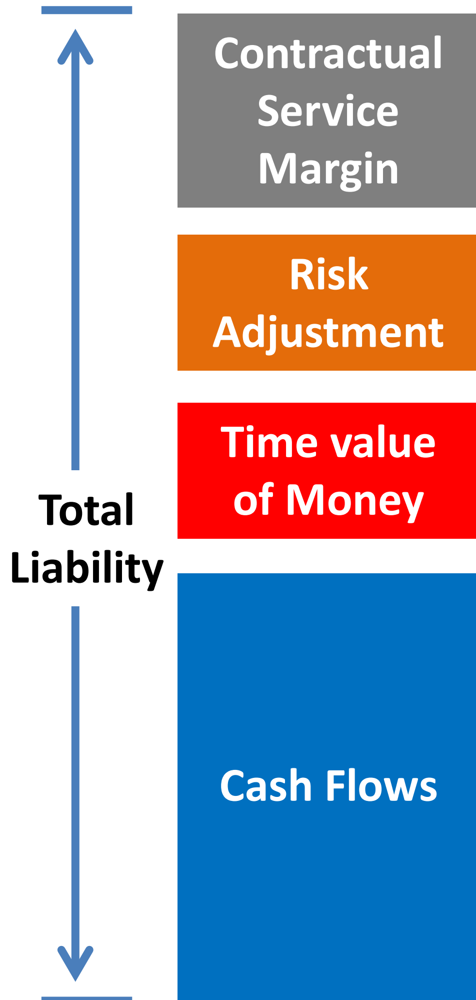
Overview - IFRS Insurance



- Insurance Contracts Liability remains a Current Value Measurement based on the key Building Blocks (BB):
  - Cash flows – expected value not best estimate
  - Time value of money – discounted present value
  - Risk adjustment – the compensation the insurer requires for bearing risk
- Insurance Contracts Liability also :
  - includes an unlocked Contractual Service Margin (eliminating profit at inception) which is released over the coverage period consistent with the transfer of services.
  - for onerous contracts includes the risk adjustment.
- Simplified Measurement using the Premium Allocation Approach (PPA) permitted when it is a reasonable approximation to BB or if coverage period is twelve months or less.

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Overview - IFRS Insurance

In response to strong concerns about volatility in Profit and Loss under the 2010 ED, the IASB have proposed:

- Unlocking the contractual service margin for changes in estimates.
- Presenting the change in Insurance Liabilities due to discount rates in Other Comprehensive Income (OCI).
- Introduced mirroring where there is a contractual link to assets and liabilities underlying insurance contract (Par & Unit Linked).

Other Key changes, not subject to further consultation are:

- Allowing top down approaches to determining discount rates, which can reduce impacts of credit rate spread changes (in practice).
- Changes to the Contract Boundary in concerns from Health Insurers:
  - Now ends when no longer required to provide coverage or can fully reprice the contract or portfolio.
  - **Means that Health Insurance and yearly renewable insurance contracts are now short term contracts.**

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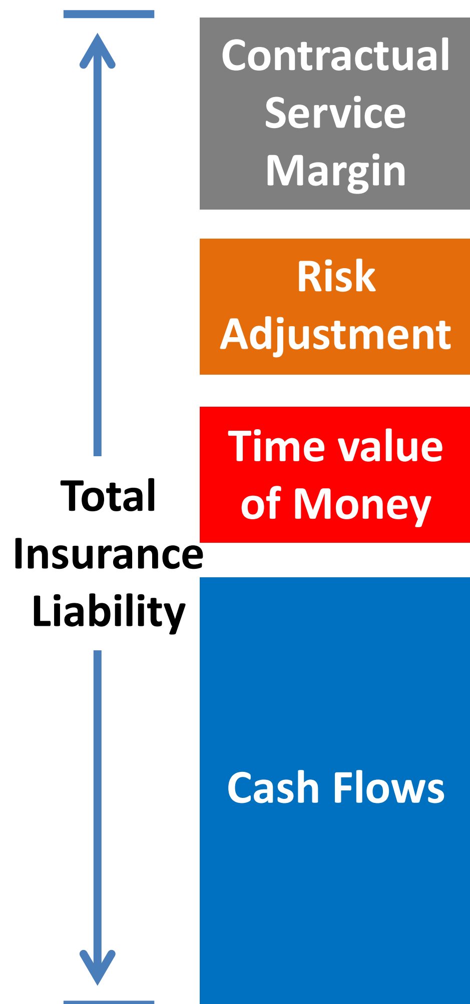
Overview – Limited Re-Exposure

- While the ED included the full text of proposed standard, IASB did not want to re-open issues that they viewed as having been already sufficiently exposed and deliberated
- Limited number of Questions will be asked to avoid re-opening.
- Focus of IASB targeted re-exposure is:
  - Unlocking the Contractual Service Margin
  - Mirroring of Assets for Participating & Unit Linked Contracts
  - Presentation proposals
  - Other Comprehensive Income
  - Approach to transition
  - Costs and Benefits
  - Areas for Clarification

Adjusting the Contractual Service Margin Q1 – Proposal



- **Contractual Service Margin (CSM).**
  - Eliminates profit at inception, after allowing for risk;
  - Is released over the coverage period consistent with the transfer of services;
  - Represents expected future profit under the contract;
  - Could not be remeasured under 2010 ED.
- **ED now proposes:**
  - **Adjust** CSM for changes in **future cash flows** related to future coverage and services;
  - **Still exclude** changes in the **risk adjustment & discount rates** from re-measurement;
  - **Still use inception discount rates to unwind CSM and re-measure CSM** for changes in future cash flows related to future coverage
- **IASB Rationale** more consistent with Revenue Recognition Approach to:
  - Keep the expected future profit estimate updated; and
  - Its release aligned with future service;

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Adjusting the CSM - Q1 Response & Issues

- **We agreed with**:
  - the (CSM) being adjusted for changes in pre-claim cash flows estimates;
  - changes in claim liability estimates being recognised in profit or loss
- **We argued that** CSM should also be :
  - **adjusted for changes in the risk adjustment** for pre-claim cash flows;
  - **measured using current discount rates**, for consistency with the pre-claims fulfilment cash flows; and
- **loss reversal should be allowed**, where loss recognition has occurred;
- **Key Issues**
- We argued for adjusting the CSM last time, it fits with revenue recognition principles and has worked well in Australian MoS context.
- Supported limiting re-measurement only to changes in estimates relating to future coverage, unlike MoS, rationale is consistency with:
  - Simplified Measurement (PPA) were changes in incurred claims estimate hit current period profit; and
  - Revenue from Contracts with Customers and IASB rationale for allowing unlocking
  - ED (Para 19) which sees the liability as comprising - incurred claims liability (current & past periods) & a remaining coverage liability (future periods

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Adjusting the CSM - Q1 Key Issues Continued

- **Re-measurement should also include risk adjustment** changes relating to future coverage, rationale is:
  - As part of the estimate change relating to future coverage, this is **consistent with the IASB rationale for allowing re-measurement**.
  - it is **consistent with Simplified Measurement** (PAA) were only changes in risk adjustment for incurred claims estimates affect current period profit;
  - Reasons given by IASB in basis for conclusions (BC 37) are not relevant or incorrect. **It is not complex and is already being done for Aust GI** regulatory reporting.
- **Current discount rates not inception should be used**, opening for the unwind of CSM and closing for re-measurement, rationale is:
  - More **consistent** with the IASB intent that **Insurance Contract liability** on the balance sheet be **a current estimate**;
  - **All other components** insurance contract liability **use current discount** rates;
  - The use of **OCI,** only requires the impact of discount rate changes to be separated out and **does not necessitate the use of inception discount** rates.

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Adjusting CSM - Q1 Key Issues Continued

The ED appears not to allow Capitalised Loss reversals, this differs from MoS and the IASC argued the case for allowing capitalised loss reversals.

- **Our Rationale for supporting loss reversals** are:
  - Has worked well under MoS;
  - Provides symmetry in the treatment of onerous assumption changes;
  - Reduces the ability to rebuild of future profit margins by being unduly conservative in setting assumptions when loss recognition initially applies; and
  - It is simple to amortise the capitalised loss for the passage of time, by continuing to track the CSM when negative and base the amount available for loss reversal on this;
- Rationale Against loss reversal are:
  - It is a retrospective adjustment reversing losses from prior period;
  - It makes for a simpler process;
  - Can also reduces incentives for undue conservatism in assumptions, when recognising onerous contracts, as reduces the immediate benefit of loss reversal from subsequently improving assumptions.

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Other Comprehensive Income (OCI) – Q4

ED Proposal

- P&L based on discount rate at contract inception.
- Effect of moving to current discount rate reported in Other Comprehensive Income.
- Effectively a hybrid of amortised cost and current value.

We argued that:

- A current value approach, where all assets and liabilities go through P&L is preferable to OCI;
- If IASB wishes to retain OCI, it should be an option, available to entities who use amortised cost, in order to reduce accounting mismatches.

Key Issues

- Seen as a necessary compromise to address strong concerns from those operating a matched fixed interest /amortised cost model;
- Absence of a clear definition or statement of principle for OCI from IASB.
- Does not address accounting mismatches for liabilities backed by certain assets.

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Other Comprehensive Income (OCI) – Q4

Key Issues Continued

- Gives rise to profit management opportunities by crystallising unrealised gains into the P&L through sale of the relevant assets.
- Increases profit volatility on long term inflation linked claims liabilities as changes to the cpi component of nominal interest rates goes to OCI while the associated cpi change in the liability goes to P&L .
- Substantial increase in complexity.
- Overall more likely to obscure than provide useful information.
- Very much a backward step from current value.

Considerations in forming Our View

- Principle argument in favour is that current value approach on liability side is inconsistent with amortised cost on asset side.
- Consistent measurement on both sides therefore the most satisfactory solution.
- Many countries want to retail amortised cost on asset side.

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Other Comprehensive Income (OCI) – Q4

Considerations in forming Our View Continued

- Potential responses:
  1) Fair value on asset and liability side.
  2) Simplified OCI that recognises only discount rate changes in the current period.
  3) Option to use OCI.
- Response (1) unlikely to be acceptable to certain jurisdictions.
- Response (2) reduces complexity, but arguably still a backward step from full fair value approach.
- Response (3) introduces optionality, but appears most likely of the three to be acceptable to the IASB.
- Hence Our response:
  - Noted our preference for a full fair value approach.
  - But can give entities an option to use OCI.

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Mirroring for cash flows linked to assets – Q2

ED Proposal

- To the extent that liability cash flows vary directly with underlying asset values, mirror that in the measurement of those cash flows and OCI treatment.
- Decompose the liability into:
  - Cash flows that vary directly with underlying assets, measurement of this component then mirrors that of the asset and goes through P&L or OCI on the same basis as the asset.
  - Fixed cash flows measured at risk free discount rates with OCI applying.
  - Options which are subject to fair value through P&L.
- Risk adjustment and CSM released with the provision of coverage and service.

Mirroring cash flows linked to assets – Q2

Key Issues

- Good idea in theory, but detail is complex and unclear.
- The ED is unclear on the approach to decomposition.
- Interaction of mirroring and recognition through OCI is complex, confusing to users, and arguably not a faithful representation.
- **For cash flows mirroring** the assets, if the **assets** are **held at**:
  - **Fair Value** through P&L: all changes go **through P&L**.
  - **Fair Value through OCI**: **effective interest** goes thru **P&L**, **rest** thru **OCI**.
  - **Amortised cost**: **effective interest** goes thru **P&L**, **nothing** thru **OCI**, and the mirrored component of the liability is **all held at amortised cost**.
- **For fixed cash flows**: apart from the impact of **discount rate** changes **thru OCI**, changes go **thru P&L**,
- **Option components**: current period changes **through P&L**.
- **CSM goes through P&L** as released, including the unwind at the inception discount rate.
- **Risk adjustment** goes through current period **P&L**.

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Illustrative Mirroring Decomposition – Q2

Life Act Retained Profits

Policyholder Retained Profits
= Unvested Benefits => Mirrored

Shareholder Retained Profits
= Equity => Not Mirrored

MoS Policy Liability

PV future supportable bonuses
= Unvested Benefits => Mirrored

CSM

Risk Adjustment

PV future s/h profit margins

MoS Best Estimate Liability
= PV Vested Benefits + PV Expenses – PV Premiums

Part mirrored returns support shared surplus

Put Option

Fixed Component

Mirroring for cash flows linked to assets – Q2

Considerations and Our view

- Mirroring is very complex, possibly even unworkable.
- Very Significant Issues for participating and investment linked business.
- Proposed alternatives for participating business:
  - Align to local regulation.
  - Building block approach and fully 'float' the CSM.
  - Investment experience then emerges consistently for policyholder and shareholder.
- Principles based approach to unbundling of investment linked business.
- Accept that we lose some opportunities to remove accounting mismatches that mirroring offers, albeit at the price of creating others as well as very substantial complexity.

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Presentation – Q3 Proposal

- Recognises need for volume information not margins;
- Revenue excludes deposit component (amount payable on surrender)
- Discount rates impacts separated out from P&L to OCI

	20XX	Notes
Insurance contracts revenue	A	Earned premium presentation
Incurred claims and expenses	(B)	
Underwriting result	**C = A + (B)**	
Investment income	D	
Interest on insurance liability	E	Based on 'locked' discount rate at inception
Net interest and investment	**F = D + E**	
Profit or loss	**G = C + F**	
Effect of discount rate changes on insurance liability (OCI)	H	Two components: 1. Effect of changes in current period. 2. Unwind of amounts recognised in previous periods.
Total comprehensive income	**G + H**	

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Presentation – Revenue & Expenses - Q3

We supported:

- **Showing revenue and expenses** in the P&L over only showing margins and experience (previous ED's approach)
- **Excluding deposit component** from premium**,** but only where possible
- **Three part profit presentation -** underwriting, investment & discount rate for "pure" insurance only (e.g. term general & health insurance).

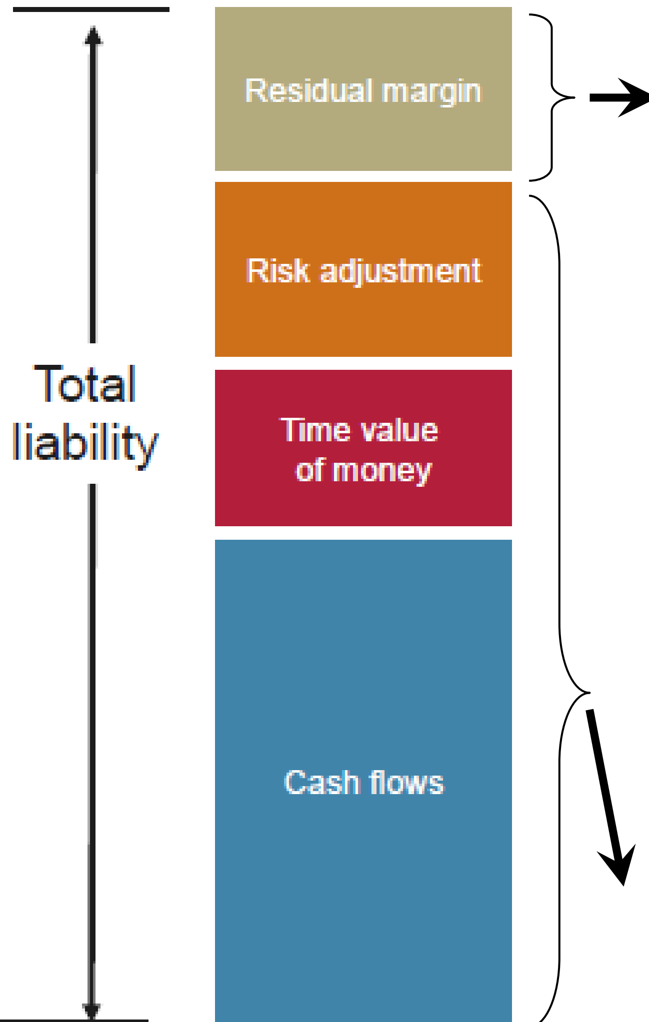
We proposed the following changes:

- **Principles based definition for Earned premium** (and fees) for revenue in place of the detailed & complex three part definition proposed
- Allow the use of written premium for traditional business, as splitting premium into deposit and insurance is difficult and arbitrary for this business and present it separately in the notes of the account.
- **For traditional and unit linked business,** do not require the three part split of profit into underwriting, investment and discount rate.

Other issues

- We also raised concerns about the volume of information required and the readability of the notes to the accounts overall.

IFRS Insurance Q5 – Transition Proposal



- Determine retrospectively as far as practicable (e.g. for past periods where retrospective assumptions and acquisition costs are available)
- If not practicable due to lack of objective data, estimate maximising use objective data available for those earlier periods
- Assume all changes in cash flow estimates since inception, known at inception
- Need inception discount rates (yield curves) for unwind of residual margin and to put to OCI the cumulative effect of the difference from current discount rates at transition.
- Beyond three years, can calibrate discount rate (over the first three years) as a margin over a yield curve observable further back and use it.

- Calculate using transition date assumptions, including for risk adjustment.

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Transition – Q5 – Our Response & Key Issues

We agreed that:

- **Retrospectively establishing contractual service margins** at transition will result in **meaningful profit** from day one;
- **A practical approach** for establishing the CSM **is provided** under the ED.

We also pointed out that:

- It will **still** be a **complex and costly exercise** to establish CSM on transition;
- **Substantial additional complexity** arises from:
  - use of **locked inception interest rates** when establishing the CSM; and
  - From the **separation of equity for OCI**;
- **Removing** the **mandatory** use of **OCI** and the **locked inception interest rates** for CSM **will make transition** much **easier**.

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Likely Effects – Costs vs benefits – Q6

ED Question:

- Are the costs of complying the standard as a whole justified by the benefits that the information will provide?
- How is this effected by changes considered in Q1 to Q5 and any alternative approach that you propose ?
- Describe the likely effect of the standard as a whole on:
  - Transparency in the financial statements of the effects of insurance contracts
  - Comparability between different issuers of insurance contracts; and
  - Compliance costs for preparers and the costs for users to understand the information produced, both initially and ongoing.

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Likely Effects – Costs vs benefits – Q6

Our submission

- **Costs incurred will be considerable** at implementation and onerous for ongoing compliance;
- There is a **large imbalance between** the **cost** of implementation **&** ongoing reporting and the **benefit** to users;
- The **changes we proposed** in our responses to Q1 to Q5 **will** improve the standard ,and **achieve a better balance** between costs and benefits;

Question 1 : Contractual Service Margin

Simpler if remeasure for **pre-fulfilment cash flows** changes including **risk adjustment** & **allow** use **current** instead of inception **discount** rates

Question 2: Mirroring

It is **very complex**, significant detail needs to be worked through, making:

- **application challenging for preparers**; and
- **understanding and comparability** as equally **challenging for users**, especially for insurers' traditional participating business.

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Likely Effects – Costs vs benefits – Q6

Question 2: Mirroring Continued

Instead:

- reduce the linked business accounting mismatch by requiring (or at least allowing) fair value for both assets and liabilities;
- float the margin for discretionary par business (as per ISAB Dec 12 paper);

Higher costs also arise from:

- Breaking the alignment of par profit for financial & regulatory reporting;
- Inability to apply a principle based approach to unbundling risk riders from unit linked business.

Question 3 Presentation

To reduce complexity and costs

- Principles based definition for Earned premium (and earned fees) for revenue in place of the detailed and complex three part definition proposed
- Allow the use of written premium for traditional business, as splitting premium into deposit and insurance is difficult and arbitrary for this business and present it separately in the notes of the account.
- For traditional and unit linked business, do not require the three part split of profit into underwriting, investment and discount rate.

Likely Effects – Costs vs benefits – Q6

Question 4: OCI

The proposed **OCI model** does **not** provide **superior** benefits relative **to the simpler** current Australian **fair value model** while incurring **substantial extra costs** to adopt and maintain, as the need to :

- disclose interest expense using **locked inception rates, means** a further **parallel valuation**; and
- determine and track locked rates for a **multitude of inception cohorts**, further complicates things

Having the option of **reporting all** interest expense through **profit or loss,** as opposed to "other comprehensive income", would:

- **remove substantial cost and complexity**, and
- **remove potential confusion to users** in jurisdictions where "mark-to-market" philosophies are firmly established in the business environment.

Question 5 : Transition

- **Removing** the mandatory use **of OCI and the locked inception interest rates** for CSM will **make transition** much **easier**.

Clarification – Q7

ED Question

- Is drafting clear and reflective of IASB decisions?
- If not, how should it be clarified

Our submission

Two key areas where change is required:

- **Unbundling** of riders from investment contracts:
  - **Agree with** the **principle** that components are distinct contracts if they could be sold separately, .
  - The **highly inter-related** test and detailed guidance on this aspect **should not over ride** the ability to unbundle were **principle** is clearly met
- Proxy **policyholders tax**
  - The test for including tax on investment income in contractual cash flows is too strong;
  - Drafting should revert to wording used in the January 2013 staff paper.

<u>We also identified a further eight areas where drafting could be improved</u>

Future Developments

- IASB will consider submissions and further development of the Insurance Standard in 2014;
- Currently there is no summary of submissions available and issues arising;
- IASB are very committed to finalising standard, but seems likely to slip further;
- My thoughts on likely developments:
  - OCI – will become optional, given strong opposition to being mandatory;
  - Mirroring – will need to re-think, may retain some elements for unit linked, not clear where par will go, but strong push from range of players for a better solution, more likely to land closer to MoS but plenty of opportunities for further surprises;
  - CSM, expect risk adjustment to be included in re-measurement, use of inception discount rates remain a risk even with change on OCI.
  - Presentation - unsure if will adopt more principles approach;
  - Transition – proposals well supported, only likely areas of change are out of changes to OCI & CSM.