Insurance alert

IASB meeting on November 19, 2014

Since a variety of viewpoints are discussed at IASB meetings, and it is often difficult to characterize the IASB's tentative conclusions, these summaries may differ in some respects from the actions published in the IASB Observer notes. In addition, tentative conclusions may be changed or modified at future IASB meetings. Decisions of the IASB become final only after completion of a formal ballot to issue a final standard.

Highlights

At this Board meeting representatives of the European Insurance CFO Forum were asked to present a paper explaining their alternative proposal for the accounting for participating contracts.

The alternative proposal would apply to all participating contracts and is based on the principles of the building block approach that applies to non-participating contracts. Options and guarantees are included as for other cash flows in the measurement, where changes in the intrinsic value of options and guarantees are recognized against the CSM. Changes in the time value are recognized in OCI where an insurer elects to recognize changes in discount rates in OCI.

Interest expense in profit or loss is determined using the current portfolio book yield approach when underlying assets are measured at amortized cost or FVOCI. The CFO Forum would allow an accounting policy for recognition of changes in discount rates in OCI or profit or loss.

Under the alternative proposal, the contractual service margin would be unlocked for movements in the assets supporting the shareholder's share, as well as unlocking for changes in cash flows and the risk adjustment related to future services. The contractual service margin is released into profit or loss in line with the services provided, which has to be selected based on the appropriate driver(s) in the contract.

This would replace the proposals in the 2013 exposure draft to apply a 'mirroring approach' to participating contracts, which was largely rejected by respondents.

The Board asked a large number of questions related to the alternative proposal, but did not take any tentative decisions. The Board will evaluate the alternative proposal in the coming months and take tentative decisions for an approach to the accounting for participating contracts in early 2015.

Participating contracts

The Board invited European Insurance CFO Forum representatives ('CFOF') to present their alternative proposal for participating contracts. The CFOF is concerned that the 2013 exposure draft and current re-deliberations do not provide an appropriate basis to explain the performance of insurance business to investors and do not adequately reflect the nature of long-term insurance contracts, particularly participating contracts. The Board asked questions about the different components of the alternative proposal, which are disclosed below together with the background to the alternative proposal.

Scope

The alternative proposal is applicable to all participating contracts as the CFOF believes these contracts are economically similar, even though they come in different forms.

Participating contracts include all contracts which provide policyholders with a right to receive, as a supplement to the guaranteed benefits, a variable return either contractually or at the discretion of the issuer. The variable return could be based upon one or more of the following:
(a) the performance of a specified pool of contracts or a specified type of contract;
(b) realized and/or unrealized investment returns on a specified pool of assets; or
(c) the profit or loss of the company, fund or other entity that issues the contract.

The scope proposal for participating contracts in the 2013 ED under the 'mirroring approach' was limited to contracts where the insurer has to contractually hold the underlying assets.

The current re-deliberations of the IASB could result in a narrower scope than the alternative proposal as only contracts with an implicit asset management fee would be in scope.

A number of questions were asked around the scope and whether assets are actually held by insurers in practice. This would be important as an insurer would need to be able to identify the underlying assets to apply the book yield approach. The CFOF noted that they mainly wanted to reflect that an insurer should not be required to hold underlying assets as this would scope out some participating contracts.

One Board member asked whether currently contracts exist where the shareholder's share is 30 or 40% (similar to a performance fee to a hedge fund) and whether this would still qualify as an implicit management fee. The CFOF noted that they are not aware of such contracts and a performance fee of a hedge fund is something completely different from an implicit management fee.

The CFOF also noted that determining whether a participating contract meets the scope criteria is only done at inception. Some Board members were concerned that the economics of a contract may change over time and may have to be reclassified. For example, when a minimum interest guarantee is expected to stay in-the-money over the life of the contract, the asset dependence becomes irrelevant. In this case, the contract is more like a non-participating contract and may have to be reclassified. The CFOF noted that some of these questions are theoretical and would be unlikely to arise in practice.

Basis of measurement

The alternative proposal is based on the principles of the building block approach and the current fulfilment value in the balance sheet framework of the 2013 ED, as well as the IASB's approach to measurement of financial instruments in IFRS 9.

One single discount yield curve is used in the alternative proposal, but the CFOF explained that entities would not be prohibited from bifurcating cash flows. The CFOF also clarified that in case a single yield curve is used this rate would have to be changed over time.

Discount rate and interest expense in profit or loss

The cash flows under a participating contract are discounted using the top-down or bottom-up rate in the alternative proposal.

Interest expense reported in the income statement is determined using the current portfolio book yield where an insurer applies amortized cost, FVOCI or mixed measurement to the underlying assets.

The current portfolio book yield is determined consistently with the investment return reported in the income statement for the assets which back the insurance contract liabilities. The book yield approach would be applied to all participating contracts to which the alternative proposal is applied.

The CFO Forum believes that an accounting policy choice should be available to recognize changes in discount rates either in OCI or profit or loss.

The CFOF noted that the mix of underlying assets should be reflected in the book yield. Some were concerned that the book yield approach would create accounting mismatches when underlying assets are investment properties or equity instruments held at FVOCI. In addition, there were concerns as to how to determine the book yield when a participating contract is not 100% asset dependent. A Board member asked why the interest expense would not just mirror the investment returns in the income statement.

One board member raised a question in relation to how the book yield approach would be applied in a risk-neutral measurement of the balance sheet (including options and guarantees). There could potentially be a mismatch if the book yield reflects asset dependence and the balance sheet is risk-neutral. The CFOF noted they would be surprised if a risk-neutral approach would be used for the balance sheet.

During the discussion, some members asked for more guidance around moving assets between portfolios and how this would impact the book yield approach. The CFOF noted this would be unusual, but could for example happen when cash flows from a portfolio are negative.

Unlocking of the contractual service margin (CSM)

The CFOF representatives noted that the core of the proposal is the full unlocking of the CSM. However, in answer to a question the CFOF confirmed that it is really a re-measurement of profit at each reporting date and then the model considers how the total profit is allocated to the different reporting periods.

In the alternative proposal the CSM represents all of the profits to be earned in the future from the provision of services under the participating contract. The CSM is unlocked for non-financial assumptions and financial assumptions, including those which are impacted by the change in value of the underlying assets and reinvestment assumptions. Changes in financial and non-financial assumptions are treated consistently for subsequent measurement of the CSM.

The CFOF believes that the unlocking of the CSM is consistent with how the CSM is measured at inception and better reflects the long-term performance of the insurer. In response to questions from Board members, the CFOF clarified that the CSM is re-measured on each reporting date. At each reporting date, the CSM represents the services that will be provided between the reporting date and the end of the contract.

The alternative proposal does not impact the way an entity applies IFRS 9, but the reported earnings are impacted by the interaction between IFRS 9 and IFRS 4.

The current re-deliberations of the Board are directed to justify recognizing the changes in shareholder's share of underlying assets against the CSM by analogizing it to an implicit management fee.

The CFOF noted that they conceptually could agree with the analogy to an implicit asset management fee to justify why the CSM is unlocked for the assets supporting the shareholder's share in underlying assets. However, the strict requirements discussed by the IASB to demonstrate this would be too restrictive as only a limited number of contracts would be in scope.

As the CSM is unlocked for investment returns, the measurement of the CSM may be different depending on the measurement of the underlying assets (such as FVOCI or FVPL). This was a concern for some Board members as investors would have to understand which amounts are recognized in profit or loss, the CSM and OCI.

One Board member asked why the CFOF did not decide to unlock the CSM for changes in discount rates to address this issue and have consistent measurement of the CSM. The CFOF noted that for non-participating contracts OCI will be used and consistency with those contracts is important. This aspect has been lower on the list of priorities of the CFOF.

As a last question on this topic, a Board member asked whether the CSM should also be re-measured for non-participating contracts. The CFOF noted that this could be an option but this has not been discussed yet.

Options and guarantees

Under the alternative proposal, there is no need to bifurcate cash flows, including options and guarantees, in a participating contract, unless they are required to be separated under the IASB's requirements for embedded derivatives. Options and guarantees that are embedded in the insurance contract are treated consistently with other elements of the insurance liability. There is no need to measure options and guarantees embedded in an insurance contract separately.

The CFO Forum paper does not discuss whether a market-consistent or real-world approach is used for the measurement of options and guarantees.

Many questions were asked on the measurement of options and guarantees and where changes in the measurement would be recognized. A number of Board members thought that all changes in options and guarantees would be recognized against the CSM and that OCI would only be used for the book yield approach. The CFOF explained that some changes, such as the time value of money, relate to changes in discount rates and should therefore be recognized in OCI where the insurer elects that accounting policy. The changes in the intrinsic value of options and guarantees are recognized against the CSM.

One board member noted that if a participating contract has a guarantee that becomes in the money during the coverage period then economically that contract would be similar to non-participating contracts with payments not being affected by underlying asset performance. The alternative proposals would treat these contracts differently.

Concerns were raised about derivatives that are entered into outside a participating fund. The CFOF explained that the CSM is unlocked for derivatives in the participating fund and for those outside of the fund which manage exposures in the contracts. The alternative proposal seems to introduce an unrestricted hedge accounting model and the Board and the CFOF agreed it should not be a free for all and restrictions should be applied.

Release of the CSM

The CSM is recognized in profit or loss over the coverage period in a systematic way that best reflects the remaining transfer of services that are provided under the contract.

Therefore, the driver for the release of the CSM in the income statement in the alternative proposal is the nature of the services provided under the participating contract.
The alternative proposal notes that for participating contracts, the services provided include administering the contract and the provision of insurance coverage but also include the provision of asset management services.

Some Board members were concerned that the release pattern in the alternative proposal is described at too high a level and that this would create diversity in practice of how profits will emerge over the life of a contract. The CFOF noted that the mix of services could be different across types of participating contracts. This should be assessed at the outset and would be disclosed. A staff member asked how services would be allocated in practice and why the pattern of services would not be updated. The CFOF believes that insurers can determine the services provided for each contract, but that it would be complex in practice to update this during the life of a contract.

One of the board members asked whether without further guidance on the pattern of release of the CSM insurers would use the same pattern for similar contracts. The CFOF confirmed that they would expect insurers to come to the same answer for similar contracts.

Unit of account

The CFOF paper notes that the insurer manages the insurance exposure and investment portfolios for participating contracts over a large number of policyholders, and potentially generations of policyholders, over a long period of time. In order to reflect the business model, the CFOF believes the CSM should be determined at a level consistent with how the insurer manages the contracts.

This is at a level of aggregation that is likely to be higher than the tentative decisions made by the Board for non-participating contracts.

A number of Board members were concerned that the alternative proposal would use an open-ended portfolio, so the CSM is unlikely to become negative. The CFOF noted that in some cases different generations have to be taken into account. If the contract is backed by the assets in a ring-fenced fund and allows for cross-subsidizing between a contract written today and a contract written 99 years ago, these contracts would be included in the same portfolio. There would be no cross-subsidizing between portfolios.

It was unclear how an open-ended portfolio would work in relation to the requirement that the CSM should be eliminated at the end of a contract. Different generations should be reflected in the measurement of the fulfilment cash flows and not in the CSM. An analogy was made to recognizing an onerous contract for construction companies which would not be done over different generations. The CFOF believes that if the contractual arrangements allow for offsetting gains and losses over generations, these contracts should be included in one portfolio. This definition of a portfolio would be used throughout the measurement model for all different building blocks.

A board member noted that the mutualisation between different generations of policyholders affects the best estimate liability but they had not considered this would apply to the CSM which reflects the shareholder's interest in the contract, rather than the policyholder's share.

Presentation and disclosure

Further disclosures of the different components or different aggregation levels could provide more detailed and granular insights into development of estimated future profitability. Similarly, further analyses could also be done (e.g. for 'release for services provided'), which would illustrate the contribution of different profit sources to the overall profitability of the contracts.

There was a request from a Board member to disclose the expected run-off of the CSM in future years and make changes in options and guarantees visible in the CSM roll forward schedules. He also asked for an appropriate level of aggregation, which could be the portfolio level. The CFOF confirmed this could be done and is partially already current practice under embedded value reporting.

Contact us:

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