Insurance alert

IASB meeting on February 19, 2015

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 education session, the staff outlined the application of the IASB's tentative decisions on the level of aggregation in accounting for insurance contracts generally, and more briefly for contracts with participating features. The Board did not make any decisions, but discussed various examples to explain the principles for the level of aggregation to be applied in the insurance contracts standard.

In the Board's view, aggregation of contracts does not meet the objective of the standard if significantly different groups of policyholders are combined because this leads to different outcomes compared to measuring the individual contracts. This is a critical point in measuring the contractual service margin (CSM) at inception and subsequently when it is unlocked for changes in estimate. A number of Board members noted that contract duration is also important to ensure the CSM is zero once the contract is no longer in existence.

Specifically, for participating contracts this principle implies that contracts should not be aggregated if they have significantly different explicit fees, different levels of exposure to mortality risk or differing levels of exposure to financial risks (i.e. embedded financial guarantees). However, the Board noted that the impact of discretion and constraints on discretion is an important factor to consider in determining the level of aggregation for participating contracts, and recognizes that this issue needs to be explored further.

Level of aggregation for participating contracts

Application to the general model

The IASB noted that confusion about the level of aggregation might have arisen because the definition of a portfolio was used in the 2013 ED for two different purposes. The first purpose was identifying which costs should be included in the fulfilment cash flows on an expected value basis. The second purpose was to determine which contracts may be aggregated at initial recognition and thus to determine when losses would be recognised in profit or loss both at inception and throughout the coverage period.

In June 2014 the IASB clarified that the objective of the proposed standard is to provide principles for the measurement of individual contracts and only if this objective is met, contracts can be aggregated. The staff paper noted that the portfolio definition should be used only in the determination of fulfilment cash flows(e.g., when allocating overhead costs).
The principles should prevent offsetting of losses with profitable contracts, as this is inconsistent with the objectives of the standard. Although entities manage, and often measure, contracts on a portfolio basis, the contractual rights and obligations arise from individual contracts.

This principle applies throughout the standard, irrespective of whether contracts are accounted for under the building block approach, the premium allocation approach, or participating contracts. The IASB will only define a principle rather than specifically identifying the level of aggregation.

The staff discussed a number of examples. These examples are intended to illustrate why the level of aggregation matters, rather than providing prescriptive guidance. In the examples, two different groups of policyholders are identified and at the time the insurance contracts are written, there is supportable information that indicates that there are significant differences in the risk of the insured event occurring between policyholders with a certain characteristic and policyholders without that characteristic. The entity collects information that allows it to identify those with and without the characteristic and chooses to charge the same premium to both groups of policyholders. Based on the known facts at inception, the entity expects a significant difference in the expected cash outflows of both groups of policyholders.

The examples show that it is inconsistent with the objective in the standard to allow offsetting of losses between contracts in various situations, for example, contracts that have significant differences in the risk of the insured event at inception. Offsetting of contracts identified as significantly different at inception could produce different results in terms of measuring a loss at inception and subsequently when estimates of cash flows change and impact the CSM, as well as upon reversal of losses of one of the two groups of policyholders. The examples also show that individual contracts (and thus CSM relating to those individual contracts) should be derecognized when the coverage period ends.

The Board noted that it respects the law of large numbers and diversification which is the heart of the insurance business. The key intention is that onerous contracts should not be covered up with profitable ones.

The IASB accepts that entities should use reasonable and supportable information that is available (without undue cost as referred to in IFRS 9). The Board discussed that, under IFRS 9, the level of aggregation should be changed subsequently if, for example, expectations of default change after inception. For insurance contracts, the intention is that the grouping is only done at inception and groups are not subsequently segregated if circumstances change. Some Board members noted this was a conscious decision to allow a concession rather than a principle for entities that issue insurance contracts.

Concerns were expressed about what the exact level of aggregation is and it was clarified that only when the groups of policyholders are significantly different, aggregation will likely not meet the objective. However, some Board members noted the model needed to be operational.

A number of Board members repeated that the CSM should be recognized over the coverage period and cannot be included in some sort of average of a larger group of contracts. Several referred to the principle in the ED that there should be no CSM left for an individual contract that has terminated. This would suggest aggregation needs to recognize contract duration. However, some Board members would like to see further guidance on the application of this principle because they believe that the CSM can also be derecognized for a group of contracts based on an average release.

The chair noted that the Board disagrees with an industry suggestion in a letter he had received that he characterized as a large number of contracts being put in a big pot from which an average release of the CSM should be calculated. The Board believes that this will not provide a meaningful presentation of profit or loss, but one large smoothing mechanism.

Specific application to participating contracts

The Board briefly towards the end of the meeting discussed how the principles should be applied to participating contracts.

The staff described its tentative view that applying the principles of the standard for participating contracts means that in the case of significantly different explicit fees, different levels of exposure to mortality risk and differing levels of exposure to financial risks (i.e., embedded financial guarantees) aggregation would not meet the objective of the standard.

An example was provided in the staff paper of a participating contract that requires at least 90% of returns to be passed to policyholders over time, but with discretion on the allocation between Contract A and B. The staff paper concluded that such contracts could be aggregated.

The paper went on to note that in a different situation where discretionary contracts offered guarantees, if there were differing levels of guarantees between Contract A and B, they should not be aggregated, as the contracts would have different exposures to risk and a different profitability.

However, the staff acknowledged during the meeting that there is an interaction between the discretionary element inherent in some participating contracts and minimum guarantees.

The Board discussed that discretion adds a different dimension to the level of aggregation for participating contracts, because this allows insurers to influence the profitability of contracts and may justify a different level of aggregation. A few pointed out that under the terms of some participating contracts, newer generations of policyholders effectively subsidize the existing contracts by sharing in the risks and rewards of the older generations.

The Board recognizes that a better articulated principle is needed for contracts with discretionary elements. This issue will be explored further, including consideration of the accounting by mutual insurers.

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