Insurance alert

IASB meetings on June 23 and June 25, 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 the decision-making session on June 25, 2015 the IASB made several significant decisions relating to participating contracts. The Board voted to require the variable fee approach for direct participation contracts, agreed on the definition of direct participation contracts, and decided that the recognition of the contractual service margin ("CSM") in profit or loss for contracts following the variable fee approach should be based on the passage of time.

The IASB education session on June 23 considered issues surrounding the adoption of IFRS 9 *Financial Instruments* ("IFRS 9") by insurers before the new insurance standard is adopted. Concerns have been expressed that adoption of IFRS 9 (in 2018) prior to the adoption date of the new insurance standard (2019 or later) could be costly and disruptive to financial statement preparers as well as users. The Staff described the complexities of a proposal to defer the effective date of IFRS 9 for insurers and potential alternatives to the deferral through changing the measurement of insurance liabilities under IFRS 4 *Insurance Contracts* ("IFRS 4"). Although no decisions were made, the Board appeared to give positive feedback to considering changing the measurement of liabilities but also requested more input from users.

The Board also discussed in an education session the accounting mismatches that could result from the variable fee approach when an entity hedges against changing market variables using derivatives. The Board considered alternatives to reduce the accounting mismatch beyond existing cash flow and fair value hedges. No decisions were made.

Variable fee approach for direct participation contracts

The Staff prepared a summary of how the general model would work for participating contracts at initial recognition and at subsequent measurement if the variable fee model was not adopted. A key difference between the general model and the proposed variable fee approach is that under the general model, changes in estimates relating to financial components, including the effects of changes in discount rates, are recognized in profit or loss or other comprehensive income in the period in which the change occurs. In the variable fee model, these financial component changes adjust the CSM as described further below.

The Staff recommendation presented to the Board was to modify the general model for direct participation contracts so that these contracts would apply the "variable fee approach." Under the variable fee approach, returns to the entity arising from a participating contract are viewed as part of the compensation that the entity charges the policyholder for services provided under the insurance contract, rather than as a share of returns from a standalone investment.

The Staff recommended that:

(a) for contracts with direct participation features, the IASB should modify its general measurement model for accounting for insurance contracts so that changes in the estimate of the fee the entity expects to earn from the contract are adjusted in the CSM.

(b) that contracts with direct participation features should be defined as contracts which have the following criteria:

> (i) the contractual terms specify that the policyholder participates in a defined share of a clearly identified pool of underlying items;
>
> (ii) the entity expects to pay to the policyholder an amount equal to a substantial share of the returns from the underlying items; and
>
> (iii) a substantial proportion of the cash flows that the entity expects to pay to the policyholder should be expected to vary with the cash flows from the underlying items.

For contracts with direct participation features, 13 out of 14 Board members voted in favor of this variable fee approach.

9 out of 14 Board members voted in favor of criteria suggested by the Staff for use of the variable fee approach.

The IASB will discuss in a future meeting disclosure requirements for entities applying the variable fee approach. The Board also expects to discuss at a future meeting whether the general model should be modified in any way for contracts that do not meet the direct participation criteria.

Some of the Board discussions leading to the ultimate vote are described below.

One Board member suggested that the variable fee approach was not needed, as the same results could be achieved through the general model. If anything, he thought that the approach functioned more as a practical expedient.

Several Board members commented that they do not view the variable fee approach as a separate model, but as an extension of the general model reflecting the unique contract features of participating contracts. They view the variable fee as compensation for performing various services, including investment services, and thus unlocking of the CSM for these contracts is consistent with the general model and IFRS 15.

Several Board members commented that there needed to be an overarching principle or objective in applying the variable fee approach, in addition to the criteria. One suggested a link to the provision of asset management services, while the staff cautioned that participating contracts typically offer several services, including insurance services in addition to investment services. It was not clear from the discussion if the matter will be considered further by the Board.

One Board member objected to the adjustment of the CSM for changes in the value of guarantees, arguing that the insurer's decision to offer a minimum guarantee was separate from its variable fee, and had more characteristics of a financial instrument. Two other Board members said they initially had the same view. However, because the Board ultimately decided that these guarantees were so inter-related with the other performance obligations in the insurance contract that they should not be unbundled, they ultimately agreed that changes in the guarantee should be included in the CSM adjustment. One Board member pointed out that to the extent the guarantee values become so significant that they reduce the CSM to zero, they would subsequently be recognized as losses in profit or loss.

Some Board members disagreed that the variable fee approach should be used in cases where an entity does not hold underlying assets. They viewed the economic nature of the transaction as more derivative-like. However, the Staff and other Board members argued that in practice there is a varying extent to which assets are actually held by entities as underlying items in participating contracts. It would be hard to draw a line to indicate to what extent an entity should actually hold assets backing insurance liabilities to be able to apply the variable fee approach. One Board member commented that even if no underlying assets are held, entities are still providing investment services to policyholders and thus use of the variable fee approach is justified. The Staff added that indexed funds are often offered in the marketplace for a fee by other entities, and the principles of IFRS 15 are applied (i.e., treatment as a service to be recognized over time with adjustments in revenue for changes in estimates).It would be inappropriate to conclude that other principles should be used by insurers.

One Board member suggested that the second and third scope criteria might be sufficient without satisfying the first criterion that “the contract specify a determinable fee” because in some cases, a contract with discretionary returns could be “economically similar” to one that contractually provided for some minimal defined level of participation.

In response to one Board member’s observation that there were many terms used in the three qualifying criteria without strict definitions, such as ‘contract,” “underlying items,” “clearly identified pool,” “expected,” and “substantial,” the Staff responded that, consistent with the principle-based approach used for IFRS, some of the terms would require preparers to use judgement.

Some Board members referred to the educational session on hedge accounting and asked the Staff if the use of the variable fee approach was meant to be required in all cases where insurance contracts met specified criteria. The Staff confirmed that they believe the variable fee approach should be required rather than optional. They suggested this be discussed at a future session to determine if exceptions to the required use of the variable fee approach would be necessary in limited circumstances.

Some Board members disagreed that the decision on the applicability of the variable fee approach should be made only at the inception of the contract. Another Board member disagreed claiming that qualifying criteria would not be met in some periods during the life of a contract. However, this should not affect the approach adopted at the inception of a contract. The Staff also commented that under the general model the analysis is done only at inception, and reassessment of such decisions is required only when the contract changes.

Recognition pattern of CSM in profit or loss for contracts with participation features

The distinguishing feature of contracts with participation features is that the contract provides policyholders with payments that vary with the returns on assets. Accordingly, many believe that insurance contracts with participation features provide investment-related services in addition to insurance coverage.

The Staff recommended that, for insurance contracts with participation features, an entity should recognize the contractual service margin in profit or loss on the basis of the passage of time.

12 out of 14 Board members voted in favor of recognition of the contractual service margin in profit or loss on the basis of the passage of time for insurance contracts with participation features.

Many Board members agreed with the Staff recommendation, noting that because insurance contracts combine several components that are typically not sold separately and are interrelated, there is no easy way to allocate the components and thus accurately determine a pattern of revenue recognition other than straight-line. It was pointed out that many constituents responding to the 2013 ED noted that the principles based approach that provided for a “systematic” recognition pattern was too vague and might lead to inconsistent interpretations and non-comparability in practice. The Board members supporting the Staff believe that using the passage of time as a basis for revenue recognition is an acceptable compromise and is consistent with a similar decision for the general model.

A few Board members suggested that a choice between passage of time and another justifiable basis would be in line with the principle-based requirements in IFRS 15. One Board member used an example of a unit-linked contract, noting that fees are typically assessed as a percentage of the underlying assets, which increase over time. He thought that it would be wrong to record straight line profit recognition for these services, as it might “front end” the revenue. The Staff disagreed, arguing that revenue recognition is dependent on the services provided, which are the same over time, and not on the timing of cash collection.

Adoption of IFRS 9 before the new insurance contracts standard

In May 2015, EFRAG issued its draft endorsement advice (DEA) for the use of IFRS 9 in the European Union (EU) where it advises the European Commission to ask the IASB to defer the 2018 effective date of IFRS 9 for insurance businesses and align it with the effective date of the new insurance contracts standard.

The Staff and some Board members have conducted targeted outreach with interested parties to better understand the issues that could arise for the insurance industry if IFRS 9 is adopted before the new insurance contracts standard is adopted. The Staff understands that common concerns include a temporary increase in accounting mismatches and other sources of volatility in profit or loss and the costs of undergoing two consecutive sets of accounting changes in a short period of time, both for preparers and users.

Preparers are primarily concerned about potential increases in mismatches arising from the classification of assets at fair value through profit and loss (FVPL) that were not previously classified at FVPL. On adoption of the new insurance contracts standard, insurance contract liabilities may be measured on the basis of current market assumptions through profit or loss and thus the mismatches could be reduced to a large extent.

A Board member commented that the targeted outreach revealed that some preparers believe adopting IFRS 9 and IFRS 4 at the same time would be more costly. The Board member also commented that using both IFRS 9 and IAS 39 in the same financial statements of an entity that has insurance as well as non-insurance operations (in the event the Board agrees to deferral of IFRS 9 for insurers) would make the financial statements less understandable for users. It was observed that this should be weighed against temporary mismatches if insurers adopt IFRS 9 in 2018 in advance of the new insurance contracts standard.

The Staff commented that the opinions on deferral have been expressed mostly by preparers and that to date users have not actively expressed their views on the subject, to which a Board member responded that users' opinions were important and that more research should be conducted.

As this was an educational session, no decisions were taken.

Use of IFRS 4 existing guidance and potential amendments to address the consequences of adopting IFRS 9 before the new insurance contracts standard

As a potential alternative to deferring the effective date of IFRS 9 for insurers, the Board discussed alternatives focused on reducing asset/liability mismatches affecting profit or loss by changing the recognition of insurance liabilities. The Staff noted that insurers have the ability to reduce accounting mismatches under existing IFRS 4 through the use of current market interest rates for valuation of liabilities and through shadow accounting for participating contracts. Under shadow accounting, insurance liabilities are adjusted to reduce accounting mismatches that can arise when unrealized gains and losses on assets are recognized. IFRS 4 allows an entity to change its accounting policies if the changes make the financial statements more relevant, which means that insurers might be able to adopt new policies under existing IFRS 4.

The Staff proposed that the IASB could also seek to reduce accounting mismatches and other sources of volatility by one or both of the following amendments to existing IFRS 4:

(a) Allow application of shadow accounting when gains or losses from assets have no direct effect on measurement of liabilities or when those gains and losses would be attributable to the entity and not the policyholder.

(b) Permit entities to recognize a liability adjustment to reflect the differences between the change in value of the assets under IAS 39, and the change in their fair value under IFRS 9 to the extent that those changes are recognized in profit or loss.

A number of Board members seemed to express preliminary support for the idea of timely adoption of IFRS 9 and having some adjustments to the insurance liabilities as a temporary solution. They noted that if IFRS 9 is not adopted by insurers on the 2018 effective date, users would be disadvantaged from the standpoint of financial instrument reporting for several years. They did, however, acknowledge concerns about the cost and additional effort that a "temporary liability solution" would entail for preparers and potential confusion for users.

As this was an educational session, no decisions were taken.

Complexity of deferring the effective date of IFRS 9 for the insurance industry

The Staff noted that providing a deferral for insurers in the adoption of IFRS 9 may be more costly and complex than some had originally expected. If the IASB were to defer the effective date of IFRS 9 for the insurance industry, it would need to:

(a) determine the scope of the deferral, including the level in a reporting entity to which the deferral would apply and the qualifying conditions for a deferral;

(b) assess whether there is a need for particular presentation and disclosure requirements; and

(c) identify whether there are any accounting consequences of the deferral that need be addressed and develop necessary guidance (for example, if IAS 39 and IFRS 9 were applied to different subsidiaries within a single reporting entity and those subsidiaries transferred financial assets to each other).

One Board member supported the deferral of IFRS 9 arguing that it would be reasonable to change assets and liabilities at the same time as they are interrelated. Insurers would justifiably want to consider decisions they make for assets together with the decisions they make for liabilities.

The Staff have identified three broad approaches for deferring IFRS 9 for insurers:

(1) <u>Reporting entity level</u>: each reporting entity would apply either IFRS 9 or IAS 39 to all its financial instruments. For a reporting entity with both insurance and non-insurance operations, this would require consideration of how significant the insurance operations need to be to conclude that an entire entity could use IAS 39 until the effective date of the insurance standard. In addition, if subsidiaries had separate reporting requirements, for example an insurance subsidiary reporting entity and a banking subsidiary reporting entity, the former would follow IAS 39 while the latter would follow IFRS 9 in its separately issued financial statements.

(2) <u>Legal entity level</u>: each legal entity within a reporting entity would apply either IFRS 9 or IAS 39, which could result in a reporting entity simultaneously applying both standards in its consolidated set of accounts.

(3) <u>Insurance activities level</u>: this could result in a reporting entity simultaneously applying both IFRS 9 and IAS 39 in a single set of financial statements, even if it were a single legal entity. This approach would be the most complex, requiring insurance activities and related assets to be tracked below the level of a legal entity.

Board members expressed mixed views about the approaches. Some opposed Approaches 2 and 3, noting that they violate the IAS 8 requirement to use consistent accounting policies for similar transactions within an entity. They added that having mixed models within an entity creates significant costs and complexity for preparers and users, and would require additional guidance on how transfers of assets should be handled within a reporting entity.

Others viewed the deferral of IFRS 9 at a level below the reporting entity as an acceptable alternative assuming there are rules for transfers within a reporting entity. One Board member noted that whilst transfers of assets may be rare the Board would still need to be clear on how any transfers could be accounted for, which may be complex. One Board member commented that bank regulators would prefer to see IFRS 9 adoption for banking operations, which suggested they would reject Approach 1.

Some Board members noted that if insurers are able to account for financial assets under IAS 39 in the financial statements, it is likely they would also have to prepare accounting information based on IFRS 9 either for adjusting the insurance liabilities for the difference between IFRS 9 and IAS 39 or for preparation of the disclosures based on IFRS 9.

As this was an educational session, no decisions were taken.

Hedging of risks related to insurance activities

One consequence of the variable fee approach for certain participating insurance contracts would be that the CSM would be adjusted by the effect of changes in financial market variables, for example, interest rates. However, if, as part of its risk management activities, an entity hedged itself against the risks arising from such financial market variables using a derivative, an accounting mismatch would arise because the effects of the changes in value of the derivative would be recognized in profit or loss in accordance with IAS 39 and IFRS 9.

The Staff considered the most common financial market risk components that insurance entities might hedge:

(a) duration mismatches;
(b) financial guarantees; and
(c) the entity's share in the underlying items.

The Staff paper included an analysis as to why the existing general fair value and cash flow hedge accounting models in IAS 39/IFRS 9 would likely not offer much relief for these accounting mismatches. In general, Board members were not in favor of amending hedge accounting guidance for insurance contracts.

The Board considered alternative approaches for addressing accounting mismatches created by the variable fee approach.

Approach 1: Limited application of the variable fee approach. The variable fee approach would not be applied and the general measurement model would apply instead.

Approach 2: Recognition of changes in the value of the guarantee and the entity's share in the underlying items in profit or loss instead of the CSM. An entity would be able to choose to recognize in profit or loss the effect of changes in financial market risks on the guarantee included in the insurance contract and/or on entity's share in the underlying items. However, this approach would not result in perfect accounting offset because the guarantee is measured using the fulfilment cash flow model rather than fair value.

Approach 3: Designation of the derivative as an underlying item. An entity would designate a notional derivative that exactly mitigates the entity's exposure to the identified financial market risk as part of the underlying items. Thus, changes in the insurance obligation recognized in the statement of comprehensive income that equal changes in the value of the underlying items would include changes in the value of that notional derivative.

Some Board members expressed preliminary support for Approach 3 applied conditionally on meeting specified criteria. Arguments for Approach 3 are that unlike Approach 2, guarantees would not need to be separated, and the approach is consistent with the variable fee model. However, a few Board members expressed concern that it may be difficult to accurately measure the notional derivative, which is the basis of Approach 3.

A few Board members noted that the biggest hedging issue in the variable fee approach appeared to be the mismatch caused by recognizing changes in value relating to minimum guarantees as an adjustment to CSM while the related changes in value of the hedging derivative are recognized in profit and loss. Therefore, they argued for Approach 2.

Opponents of Approach 2 (and supporters of Approach 3) argued that constituents have noted throughout the project that the guarantee component and other cash flows in an insurance contract are highly-interrelated, thus making it difficult to identify and measure the guarantee separately. However, it was further noted that it would be equally difficult to identify and accurately measure the "notional derivative" under Approach 3. The Staff paper noted that if these guarantees were separable, they would potentially qualify as embedded derivatives that should be separated from the insurance contract and valued at fair value under IAS 39/IFRS 9.

One Board member rejected Approaches 2 and 3, arguing that insurers should not receive any special treatment for hedged items. Hedged items need to be identifiable and reliably measurable by insurers as in all other industries. He might support Approach 1, which would effectively require recognition of the entire change in value of financial variables through profit or loss or in other comprehensive income.

As this was an educational session, no decisions were taken.

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Contact us:

If you would like to discuss any of the issues raised in this summary, please contact Gail Tucker or Mary Saslow or speak with your usual contact at PwC.

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