Overview

This insurance accounting alert covers topics addressed at both the November and December 2012 meetings. At the November joint meeting, the International Accounting Standards Board and the Financial Accounting Standards Board (respectively, the IASB and the FASB, and collectively, the Boards) re-deliberated the decisions in the IASB’s Exposure Draft Insurance Contracts (ED) and in the FASB’s Discussion Paper, Preliminary Views on Insurance Contracts (DP).

The Boards discussed how tentative decisions made would apply to contracts whose cash flows are affected by expected asset returns, but to which the ‘mirroring approach’ does not apply.

- Should the interest accretion discount rate be locked in
- How to present changes in the discount rates

In December, the IASB held a separate meeting in which it covered the following issues/topics:

- The mechanics of how to apply unlocking the residual margin to avoid some unintended consequences
- An alternative approach to unlocking the residual margin (‘floating’ residual margin) for participating contracts

Overview of contracts with participating features

Insurance contracts often contain features that provide the policyholder with an investment return that is affected by the performance of assets; throughout this project, they have been referred to as participating features. Some of these contracts contain a contractual right to share in the return of specified underlying assets held by the insurer. The Boards have labelled these participating contracts.

What you should know

- The Boards clarified how previous decisions should apply to contracts that contain cash flows affected by asset returns but to which the ‘mirroring approach’ does not apply.
- The IASB decided that the residual margin should not be unlocked for certain gains and losses arising from the underlying assets for participating contracts.
- It also clarified that the residual margin only should be unlocked for changes in estimates of cash flows relating to future insured events and other future services.
- Under the IASB’s model, the initial residual margin included in reinsurance assets will be determined using the lifetime expected losses, with subsequent changes in expected credit losses being recognised in profit or loss.
In previous meetings, the Boards concluded that clarification was needed regarding how to apply the building block approach to participating contracts and they developed the ‘mirroring approach’ guidance. The key clarification under the mirroring approach is that the portion of the cash flows relating to the contractual participating feature is measured consistently with the underlying assets. Also, the effect of discount rate changes related to the contractual participating feature will be presented consistently with the impact of interest rate changes on the underlying assets in the statement of comprehensive income.

The purpose of this clarification is to make sure that accounting mismatches between measurement of the contractually-linked participating contract cash flows and the underlying assets would not occur.

**Contracts with participating features to which the mirroring approach does not apply**

While the mirroring accounting addressed participating contracts, the staff pointed out that there could still be an unintended consequence for some contracts with participating features. They noted, in particular, those contracts where the asset-dependency is not the result of a contractual right to share in the returns of specified underlying assets held by the insurer.

The staff indicated that the most common example of such a contract is a universal-life policy, where investment returns are affected by asset performance, but the credited interest is at the insurer’s discretion. Another example is an index-linked policy that provides a contractual right to the performance of specified assets (the index), but those underlying assets are not held by the insurer. While those contracts both contain participating features, they would not be considered ‘participating contracts’ under the Boards’ current view because there is no contractual linkage to assets held by the insurer. As a result, the mirroring approach would not apply to those contracts, and the discount rate used to determine the liability may not be reflective of the dependency on the performance of designated assets.

**Clarifying previous decisions**

The staff felt it was necessary to clarify how previous decisions on estimating the discount rates would apply to contracts with participating features to which the mirroring approach does not apply. Specifically, they indicated that, to the extent the cash flows are dependent on the performance of a specified pool of assets, the discount rate used to determine the liability should reflect that dependency.

Some Board members asked whether it was necessary to make any clarification considering the insurance contracts standard is principle-based. Others questioned how management would make a judgement on a contract’s dependency on asset returns in situations where the cash flows’ contractual linkage to asset returns was not obvious. These Board members suggested that an insurer should not look to the assets unless there is a contractual linkage; otherwise, the cash flow characteristics of the liability should determine the discount rate.

The staff further explained that their intention was not to deviate from the principle, but merely to seek clarification on how the guidance applies to contracts with participating features to which the mirroring approach does not apply. They believe that asset-dependent crediting rates for such contracts create a risk-sharing aspect to the contract, so the expected asset return is a relevant characteristic of the insurance liability.

A majority of the Board members voted in favour of clarifying a discount rate for insurance contracts with participating features to which the mirroring approach does not apply. That rate should reflect the characteristics of the liability to the extent to which the expected cash flows are affected by the return from assets, regardless of whether:

1. The transfers of the expected returns of those assets are the result of the exercise of the insurer’s discretion

Or

2. The specified assets are held by the insurer
The Boards also discussed whether changes in the discount rate should be presented in other comprehensive income (OCI) or as part of the interest expense in profit or loss for contracts with participating features to which the mirroring approach does not apply. Despite the Board’s previous decision that the interest expense should be based on the locked-in rate, the staff expressed its belief that resetting the discount rate for determining the interest expense in profit or loss would result in more useful information.

The Boards agreed and made a tentative decision: when there is a change in the expected cash flows used to measure the insurance contract’s liability caused by an expected change in crediting rate, an insurer should reset the discount rate that is used to determine the interest expense in profit or loss to that expected crediting rate. The Board noted that, since this expected crediting rate would also be applied to the liability measurement, the effects of changes in discount rates for the participating cash flow portion of contracts would be presented in profit or loss instead of OCI.

How we see it

A significant effort was undertaken by the Boards to mitigate concerns about the earnings volatility of insurance contracts with participating features. As a result, changes in the insurance liability resulting from changes in the discount rate will be split between OCI and net income, depending on the components (e.g., impacted by the changes in crediting rate) of the cash flows for those contracts. This signals that, while the revisions to the model may reduce the potential for earnings volatility, they come with a potential for increased operational complexity.

Further clarification by the Boards on how to apply certain aspects of the proposals on participating contracts seems necessary. For example, how to distinguish between the variable portion and the fixed portion of the cash flows, and between cash flows that are affected by asset returns and those that are not.

The IASB staff seemed apprehensive about the potential complexity. At the end of the December meeting, they noted that they were currently investigating the distinction between variable and fixed cash flows of contracts with participating features.

Floating residual margin for participating contracts

At its December meeting, the IASB discussed a proposal raised by some industry groups to apply a ‘floating’ margin approach for participating contracts. This proposal would adjust the residual margin to represent the unearned profit of insurance contracts, including the insurer’s share of asset management fees and asset returns. The residual margin defers the profit or loss recognition of gains and losses arising from the change of underlying items; for example, the insurer’s interest in assets supporting the participating contracts or insurance experience (e.g., mortality gains). The floating margin would then be released into profit or loss when distributions (i.e., dividends declared) to the participating contract holders occur.

The industry proposal included an allocation mechanism for the residual margin that would be reflective of the profit-sharing mechanism. Proponents believe this would be consistent with the guidance from the revenue recognition proposals that constrain the recognised revenue to amounts that are reasonably assured.

Although the IASB staff recommended adopting a floating residual margin for such contracts, they noted that their reasoning differed from industry groups. Their view was that an insurer can decide to also participate in underlying items, along with the participating contract holders, as a way to be compensated for the services they offer. They see the change in the value of underlying items as a proxy for updated premiums for the services provided.
Both the IASB and FASB have focused on mitigating the potential for earnings volatility that is caused by accounting and would not be reflective of the economics. However, the IASB decision not to adopt the floating residual margin makes it clear that it will not address volatility that the Board considers to be a reflection of the economic circumstances of the contract.

Application of unlocking the residual margin
The IASB revisited unlocking the residual margin to discuss some possible unintended consequences of its current decisions. They previously decided that all differences in past cash flows (i.e., experience adjustments) are recognised immediately in profit or loss, whereas all changes in estimates of future cash flows are added to or deducted from the residual margin. The staff and some constituents observed that this distinction works well for changes in estimates of claims for future insured events, but could have unintended consequences for some changes in estimates that relate to past events.

For example, a higher-than-expected lapse rate results in higher-than-expected period surrender payments in excess of expected payments (an experience difference) immediately in profit or loss. The residual margin would also increase for the reduction in future net cash outflows (a change in the future cash flow estimate), even though the current surrenders caused the change. This interpretation would result in recognising greater losses in the current period than if the impact of the current estimates were combined with the future estimates that are directly related to that current period event.

To improve alignment between the effects of cash flow changes, the staff recommended that the residual margin should be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services. In other words, cash flow effects relating to past insured events and services already provided are recognised in profit or loss in the period. Changes in estimates of cash flows relating to future insurance coverage and other future services are both adjusted to the residual margin.

While all Board members agreed with the staff recommendation, one member questioned whether this revised application would be in line with constituents’ expectations. The staff noted the Board’s discussion was a result of issues being raised recently. A full evaluation would follow in the forthcoming revised exposure draft, as the residual margin unlocking is one of the areas where the IASB will seek input.
How we see it

The IASB’s decision to distinguish which future cash flows can be considered when unlocking the residual margin means that insurers need to consider how to apply this distinction in their systems. Insurers may have to calculate several separate estimates of the changes in future expected cash flows to be able to identify those changes caused by a current event.

The issue of how to distinguish experience results from changes in estimates also existed in the 2010 ED, but only as a matter of classification within the income statement because both experience results and changes in estimates of cash flows were recognised in profit or loss.

Impairment of reinsurance assets

The IASB discussed how to account for the credit losses on reinsurance assets held by cedants. Previously, it decided that the model should consider reinsurers’ credit risk, and to use the impairment model from IFRS 9 Financial Instruments for determining and booking the losses. The IASB’s decisions on unlocking the residual margin creates a follow-up issue with the previous impairment decision: are (changes in) credit losses to be booked against the residual margin or should they be recognised in profit or loss?

The staff reminded the Board that, for prospective reinsurance contracts, both day-one gains and losses would be spread through the residual margin. They identified two alternatives:

1. Ignore the IFRS 9 impairment proposals when determining the residual margin: calibrate the residual margin on day one, considering lifetime expected losses. Subsequently, all changes in expected cash flows are recognised in the residual margin, including those relating to credit.

2. Consider impairment proposals to overlay unlocking the residual margin: an insurer would recognise the portion relating to the 12-month expected loss to profit or loss. In case of a significant change in the credit quality of the reinsurer, the insurer recognises the full lifetime expected loss in profit or loss.

The staff recommended the first alternative because this would result in the consistent application of unlocking to changes in expected cash flows within the insurance model.

Board members had several comments, as neither alternative aligned perfectly with their views. The Board acknowledged that the insurance model is a full lifetime expected loss model, but was hesitant about something that would avoid the prompt recognition of credit losses by ‘storing’ them in the residual margin. In the end, the Board agreed to a model that combined aspects of the two alternatives presented by the staff: application of lifetime expected losses in calibrating the initial residual margin, with subsequent changes in those lifetime expected credit losses recognised in profit or loss. However, some Board members suggested the staff should think about how to articulate the basis for distinguishing between changes in credit losses (recognised in profit or loss) from other cash flow changes (adjusted to the residual margin).

Presentation and disclosure

During its recent fall meetings, the IASB staff presented a proposed text on disclosure and presentation requirements, showing modifications to the proposals in the ED to reflect previous Board decisions.

Line items presented in the statement of financial position and the statement of comprehensive income

The 2010 ED proposes that an insurer presents all rights and obligations within each portfolio of insurance contracts as a single net liability or single net asset.
The Boards have since made tentative decisions about different presentation approaches in the statement of financial position. For example, for contracts measured under the building block approach (BBA), the Boards had tentatively decided that any unconditional right to premiums or other consideration from a contract should be presented as a receivable separately from the insurance contract asset or liability. For contracts measured under the premium allocation approach (PAA), the IASB had previously, together with the FASB, decided that all rights and obligations are presented on a gross basis, and the liability for remaining coverage be presented separately from incurred claims in the statement of financial position.

At the November meeting, the IASB staff recommended that an insurer present all rights and obligations arising from a portfolio of insurance contract on a net basis in the statement of financial position. They explained that presenting components of the net liability (or asset) separately in the statement may suggest that those items are different and unrelated to each other, which could be misleading. The staff proposed confirming the presentation approach proposed in the ED.

The IASB agreed and tentatively decided that an insurer should combine all rights and obligations of an insurance contract on a net basis for presentation within the statement of financial position. Based on the proposed draft of the disclosure requirements, the IASB intends to use the portfolio of insurance contracts as the basis for aggregation; the rights and obligations from insurance contracts for each portfolio will be presented together as a single net liability or a single net asset. However, an insurer would be required to present insurance contracts and reinsurance contracts as separate line items in the statement of financial position. In the Board’s view, the general requirements for IAS 1 would be sufficient to specify the presentation requirements for the statement of comprehensive income for insurance contracts.

Further discussion on additional disclosures

At its September 2012 meeting, the IASB decided on a proposed disclosure package. However, at that time, the IASB noted it would consider any additional disclosures that might be appropriate in light of further decisions. It has subsequently reached decisions on three topics to consider for additional disclosures: participating contracts; measurement of premiums and claims in the statement of comprehensive income; and transition.

Participating contracts

The IASB discussed the disclosure requirements for insurance contracts with participating features to which the ‘mirroring’ approach applies, and tentatively decided that an insurer should disclose:

1. The carrying amounts for those insurance contracts
   And
2. If the liability of the insurance contract is based on the value of specified assets on a basis other than that reported in the preparer’s financial statements – the extent to which that difference would be passed on to policyholders

Earned premium presentation

The requirement to present earned premiums under the BBA was introduced recently by both the IASB and FASB. Therefore, the 2010 ED did not contain specific disclosure elements on this topic and the Boards discussed which information should be provided in the notes during its November meeting.

To understand the earned premiums for the BBA and align presentation and disclosure with the PAA, the Boards indicated it would be necessary to separately distinguish within the opening to closing balance reconciliation the following items:

1. The amount of the liability for remaining coverage with separate disclosure of (i) losses on initial recognition, and (ii) subsequent changes in estimates that are immediately recognised in the profit or loss account
   And
2. Liabilities for incurred claims

For contracts that are accounted for using the BBA, an insurer should disaggregate insurance contract revenue into inputs to the measure of the revenue for the period. Examples of such inputs are the claims and benefits expected to be incurred in the reporting period and the margin allocated to that period. For contracts to which the BBA is applied, an insurer should also disclose the effect of insurance contracts written in the period on the insurance contract liability, separately showing the effects of:

1. Expected present value of future cash outflows, separately highlighting the amount of acquisition costs
How we see it

While the disclosure requirements may seem onerous, there has been an attempt to balance the needs of different stakeholders (e.g., preparers, users, etc) to ensure that the financial statements are understandable. Insurers will have to perform a comprehensive evaluation of the presentation and disclosure requirements to provide disclosures that tell a coherent story about their operations and performance.

Proposed plan for fieldwork

At the September 2012 meeting, the IASB tentatively decided to re-expose its proposal for insurance contracts with subsequent deliberations limited to targeted areas. At the November meeting, the IASB considered the staff’s proposed plan for fieldwork to gather information on how the proposed standard would be applied in practice.

In addition to the staff’s plan, Board members suggested that:

1. The staff consider applying the insurance contracts standard either to a fictitious or real company to see how all the tentative decisions apply in practice
2. The fieldwork explicitly includes a disclosure package (although it was felt that the disclosure would result naturally as a way of presenting the fieldwork outcome)
3. The staff extend the invitation to participate to countries that were not included in previous fieldwork

Next Steps

While the Boards are nearing the end of their deliberations, they will continue their discussions in January 2013 to clear some of the remaining issues. The topics for the January meeting include income taxes, recognition of deferred annuity contracts and accounting for loss portfolio transfers among others.

The IASB plans to issue a revised exposure draft in the first half of 2013 and will establish a publication date for the final standard in due course. The FASB currently aims to issue its exposure draft in the same period as the IASB.
Area IFRS insurance contacts

<table>
<thead>
<tr>
<th>Global</th>
<th>Telephone</th>
<th>E-mail</th>
</tr>
</thead>
<tbody>
<tr>
<td>David Foster</td>
<td>+44 20 7951 5687</td>
<td><a href="mailto:dfoster@uk.ey.com">dfoster@uk.ey.com</a></td>
</tr>
<tr>
<td>Kevin Griffith</td>
<td>+44 20 7951 0905</td>
<td><a href="mailto:kgriffith@uk.ey.com">kgriffith@uk.ey.com</a></td>
</tr>
<tr>
<td>Christine Holmes</td>
<td>+1 515 243 2727</td>
<td><a href="mailto:christine.holmes@ey.com">christine.holmes@ey.com</a></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Actuarial</th>
<th>Telephone</th>
<th>E-mail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brian Edye (Life)</td>
<td>+41 58 286 4224</td>
<td><a href="mailto:brian.edey@ch.ey.com">brian.edey@ch.ey.com</a></td>
</tr>
<tr>
<td>Alex Lee (Property/casualty)</td>
<td>+44 20 7951 1047</td>
<td><a href="mailto:ale6@uk.ey.com">ale6@uk.ey.com</a></td>
</tr>
<tr>
<td>Mark Freedman (Life)</td>
<td>+1 215 448 5012</td>
<td><a href="mailto:mark.freedman@ey.com">mark.freedman@ey.com</a></td>
</tr>
<tr>
<td>Liam McFarlane (Property/casualty)</td>
<td>+1 416 941 7751</td>
<td><a href="mailto:liam.mcfarlane@ca.ey.com">liam.mcfarlane@ca.ey.com</a></td>
</tr>
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<table>
<thead>
<tr>
<th>Americas</th>
<th>Telephone</th>
<th>E-mail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Richard Lynch</td>
<td>+1 212 773 5601</td>
<td><a href="mailto:richard.lynch@ey.com">richard.lynch@ey.com</a></td>
</tr>
<tr>
<td>Carol Carlson</td>
<td>+1 617 375 1431</td>
<td><a href="mailto:carol.carlson@ey.com">carol.carlson@ey.com</a></td>
</tr>
<tr>
<td>Doug McPhie</td>
<td>+1 416 943 3800</td>
<td><a href="mailto:doug.mcphie@ca.ey.com">doug.mcphie@ca.ey.com</a></td>
</tr>
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<table>
<thead>
<tr>
<th>Asia Pacific</th>
<th>Telephone</th>
<th>E-mail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kieren Cummings (Hong Kong)</td>
<td>+85 2 2846 9888</td>
<td><a href="mailto:kieren.cummings@hk.ey.com">kieren.cummings@hk.ey.com</a></td>
</tr>
<tr>
<td>Mark Raumer (Australia)</td>
<td>+61 2 9248 4832</td>
<td><a href="mailto:mark.raumer@au.ey.com">mark.raumer@au.ey.com</a></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Europe, Middle East, India and Africa</th>
<th>Telephone</th>
<th>E-mail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rolf Bächler (Switzerland)</td>
<td>+41 58 286 44 95</td>
<td><a href="mailto:rolf.bachler@ch.ey.com">rolf.bachler@ch.ey.com</a></td>
</tr>
<tr>
<td>Justin Balcombe (Dubai)</td>
<td>+971 5660 31149</td>
<td><a href="mailto:justin.balcombe@ey.com">justin.balcombe@ey.com</a></td>
</tr>
<tr>
<td>Gordon Bennie (Bahrain)</td>
<td>+ 973 1751 4717</td>
<td><a href="mailto:gordon.bennie@bh.ey.com">gordon.bennie@bh.ey.com</a></td>
</tr>
<tr>
<td>Jan Niewold (The Netherlands)</td>
<td>+31 88 407 2734</td>
<td><a href="mailto:jan.niewold@nl.ey.com">jan.niewold@nl.ey.com</a></td>
</tr>
<tr>
<td>Cornea De Villiers (South Africa)</td>
<td>+27 21 443 0364</td>
<td><a href="mailto:corneadeviliers@za.ey.com">corneadeviliers@za.ey.com</a></td>
</tr>
<tr>
<td>Adam Fornalik (Poland)</td>
<td>+48 225577192</td>
<td><a href="mailto:adam.fornalik@pl.ey.com">adam.fornalik@pl.ey.com</a></td>
</tr>
<tr>
<td>Pedro Garcia Langa (Spain)</td>
<td>+34 915 727 812</td>
<td><a href="mailto:pedro.gargialanga@es.ey.com">pedro.gargialanga@es.ey.com</a></td>
</tr>
<tr>
<td>Prasanth Govindapuram (Bahrain)</td>
<td>+973 3999 1972</td>
<td><a href="mailto:prasanth.govindapuram@bh.ey.com">prasanth.govindapuram@bh.ey.com</a></td>
</tr>
<tr>
<td>Jaspers Kolsters (UK)</td>
<td>+44 20 7951 6977</td>
<td><a href="mailto:jkolsters@uk.ey.com">jkolsters@uk.ey.com</a></td>
</tr>
<tr>
<td>Loic Moan (France)</td>
<td>+33 1 46 93 42 02</td>
<td><a href="mailto:loic.moan@fr.ey.com">loic.moan@fr.ey.com</a></td>
</tr>
<tr>
<td>Gabriele Pieragnoli (Italy)</td>
<td>+39 027 221 2434</td>
<td><a href="mailto:gabriele.pieragnoli@it.ey.com">gabriele.pieragnoli@it.ey.com</a></td>
</tr>
<tr>
<td>Rohan Sachdev (India)</td>
<td>+91 22 4035 6300</td>
<td><a href="mailto:rohan.sachdev@in.ey.com">rohan.sachdev@in.ey.com</a></td>
</tr>
<tr>
<td>Stefan Schmid (Switzerland)</td>
<td>+41 58 286 3416</td>
<td><a href="mailto:stefan.schmid@ch.ey.com">stefan.schmid@ch.ey.com</a></td>
</tr>
<tr>
<td>Nicole Verheyen (Belgium)</td>
<td>+32 3 270 1394</td>
<td><a href="mailto:nicole.verheyen@be.ey.com">nicole.verheyen@be.ey.com</a></td>
</tr>
<tr>
<td>Ralf Widmann (Germany)</td>
<td>+49 711 9881 15142</td>
<td><a href="mailto:ralf.widmann@de.ey.com">ralf.widmann@de.ey.com</a></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Japan</th>
<th>Telephone</th>
<th>E-mail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Peter Gaydon</td>
<td>+81 3 3503 2998</td>
<td><a href="mailto:gaydon.ptr@shinnihon.or.jp">gaydon.ptr@shinnihon.or.jp</a></td>
</tr>
<tr>
<td>Kenji Usukura</td>
<td>+81 3 3503 1191</td>
<td><a href="mailto:usukura-kenji@shinnihon.or.jp">usukura-kenji@shinnihon.or.jp</a></td>
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</table>

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