

Updates on Exposure Draft, *Insurance Contracts*

14 November 2014

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Agenda

- ▶ Background and timeline
- ▶ Highlights of the 2013 Exposure Draft (ED)
- ▶ Updates on Re-deliberations of the International Accounting Standards Board (IASB)
 - ▶ Five areas
 - ▶ Other areas
- ▶ Next steps of the IASB



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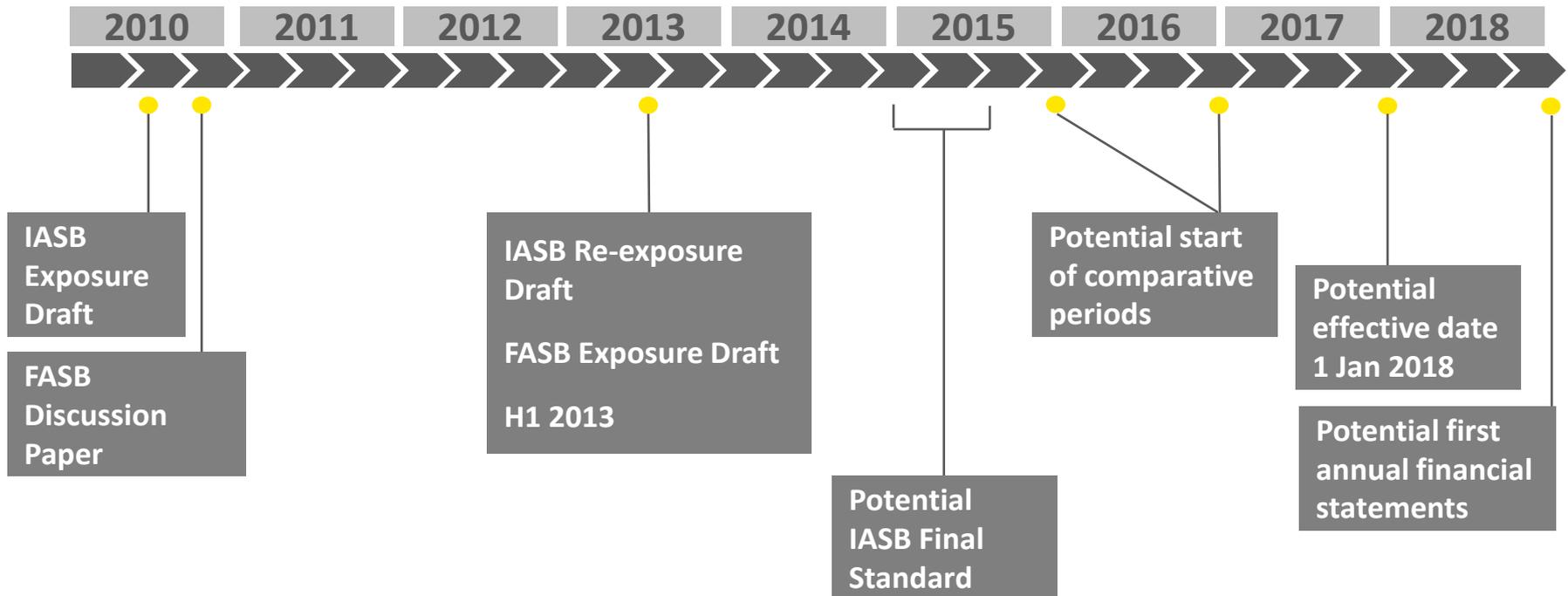
BACKGROUND AND TIMELINE



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New IFRS standard for insurance contracts

Expected to be mandatory 2018?



Ongoing FASB/IASB deliberations

Implementation period

Reporting

Other considerations: IFRS 9 mandatory effective date – 2018

New EU Regulatory framework (Solvency II) starts – 2016



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HIGHLIGHTS OF THE 2013 ED

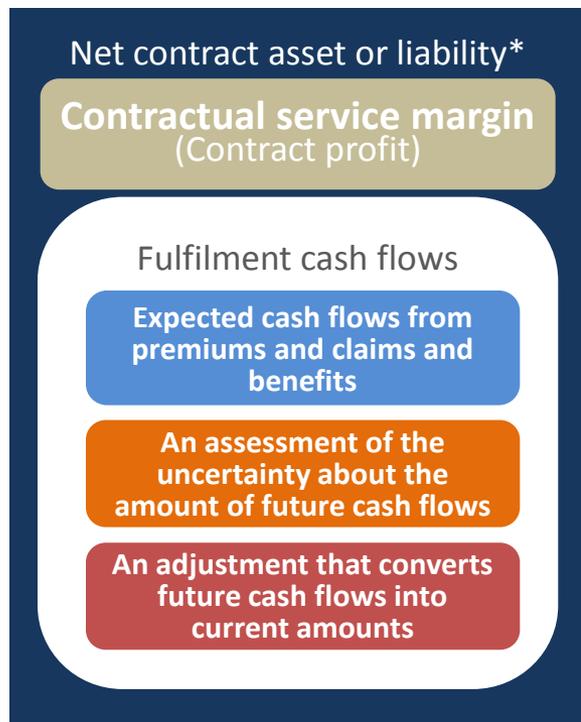


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2013 ED on Insurance Contracts

Measurement: Building Block Model

Measurement of insurance contract has two components:



Contractual service margin represents expected contract profit

Fulfilment cash flows represent a current, updated estimate of amounts the company expects to collect for premiums and pay out for claims, benefits and expenses, adjusted for risk and time value of money

Source: IASB website (Work plan for IFRS: Insurance Contracts)



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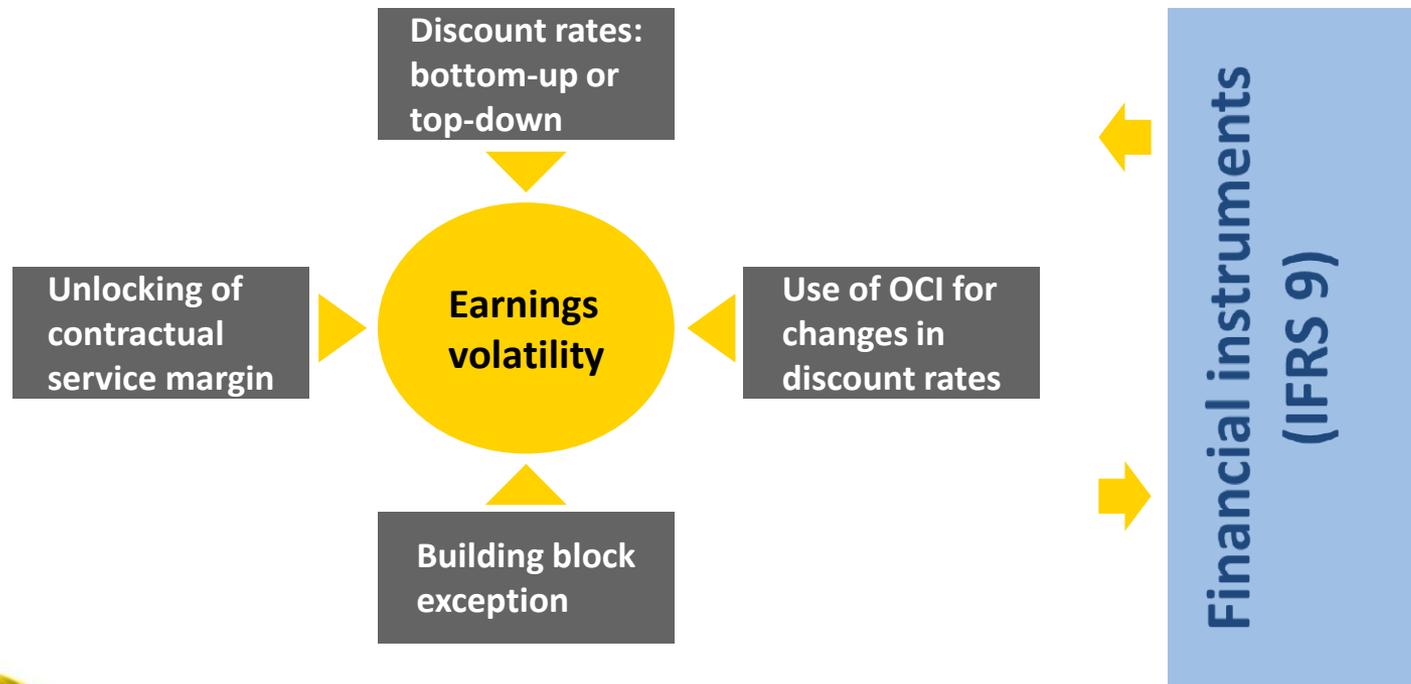
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Volatility – A key area of debate

- ▶ Several changes made to mitigate earnings volatility, but with a potential for increased operational complexity



Five targeted topics under the 2013 ED

- ▶ Unlocking the contractual service margin
- ▶ Participating contracts
- ▶ Insurance contract revenue
- ▶ Other comprehensive income (OCI)
- ▶ Approach to transition



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Measurement Proposals

Contractual Service Margin

Contractual Service Margin

- ▶ Represents the unearned profit that the entity recognizes as it provides services under the insurance contract
- ▶ Recognized on day 1 to eliminate any profits
- ▶ An entity shall recognize the contractual service margin in profit or loss over the coverage period in the systematic way that best reflects the transfer of services that are provided under the contract



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Measurement Proposals

Contractual Service Margin

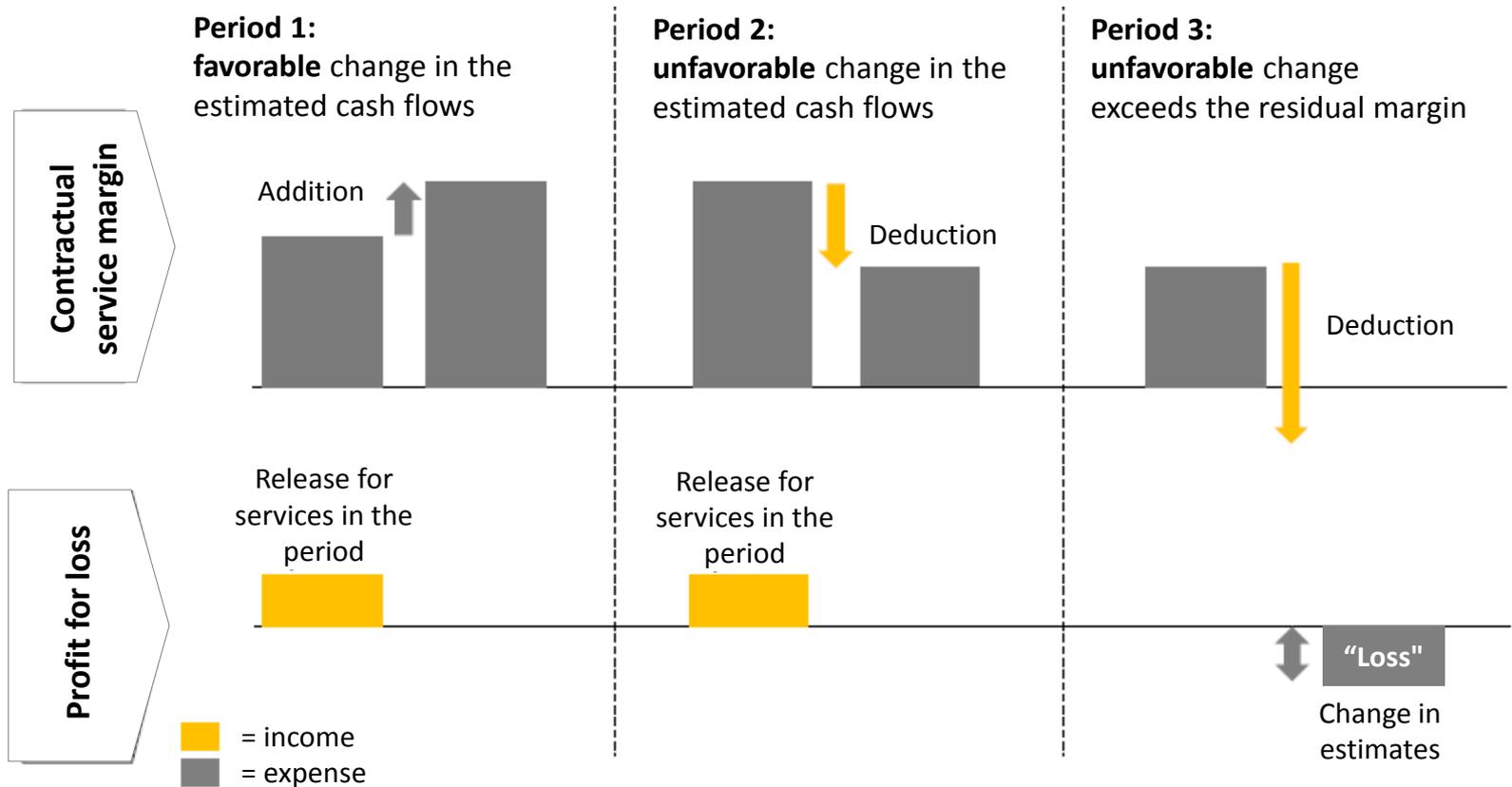
Contractual Service Margin (cont.)

- ▶ Interest is accreted using that discount rate when the contract was initially recognized
- ▶ Adjusted subsequently for differences between the current and previous estimates of the present value of future cash flows that relate to future coverage and other future services
- ▶ For unfavorable changes, these are adjusted to the contractual service margin to the extent sufficient since the balance cannot be negative



Measurement Proposals

Contractual Service Margin (Unlocking cash flow changes)



Source: EY Global Insurance Center



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Measurement Proposals

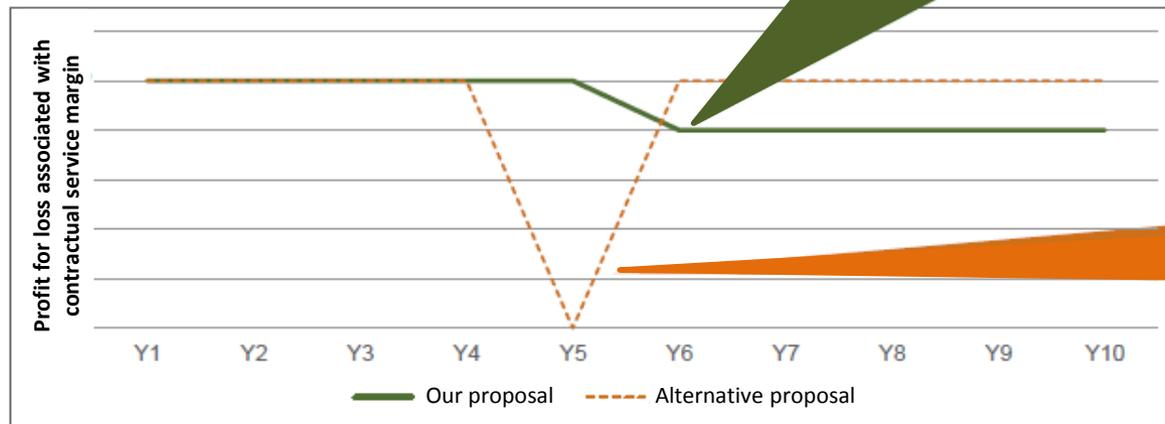
Contractual Service Margin (Unlocking cash flow changes)

Changes in estimates of cash flows affect the amount of profit the company expects to earn for providing future services. Should such changes in estimates be reflected in the period of change or as future services are provided?

Any changes in estimates relating to the profits to be earned from an insurance contract are recognized over the remaining coverage period

Source: IASB website (Work plan for IFRS: Insurance Contracts)

Revised ED



All changes in estimates are recognized immediately in profit or loss

2010 Proposal

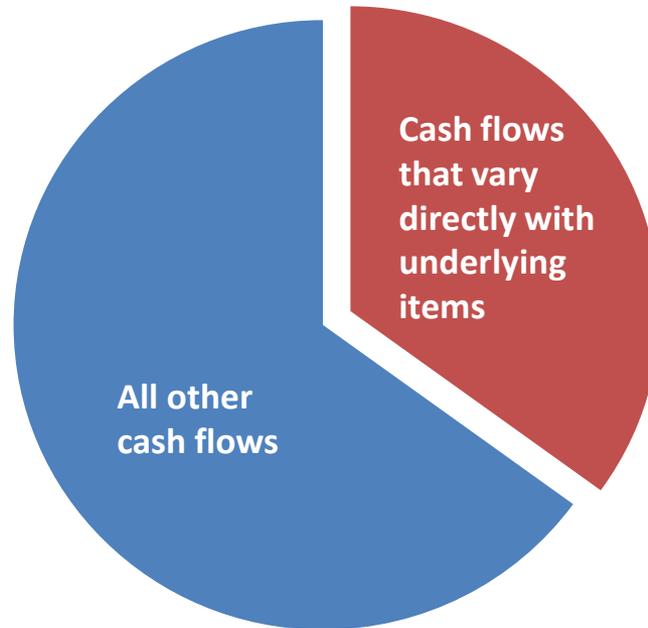


Measurement Proposals

Certain Contracts with Participating Features

Applies in situations in which there is no possibility of economic mismatch between the insurance contract and assets backing that contract, i.e., when the contract requires the entity to hold underlying items and specifies a link to returns on those underlying items.

- ▶ Measured using general requirements of the Standard. However, all changes in value of cash flows that vary indirectly with underlying items are presented in profit or loss



- ▶ Eliminate mismatch by measuring and presenting cash flows in the same way as underlying items

Source: IASB website (Work plan for IFRS: Insurance Contracts)



Measurement Proposals

Certain Contracts with Participating Features

Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items are NOT measured through the building block model (BBM). The following shall apply to this contract:

- ▶ The fulfillment cash flows of these contracts are measured by reference to the carrying amount of the underlying items
- ▶ Change is presented in the statement of comprehensive income consistent with underlying items



Measurement Proposals

Certain Contracts with Participating Features

(cont.)

- ▶ Any asymmetric risk-sharing between insurer and policyholder is reflected

	Behavior of cash flows		
	Vary directly	Vary indirectly	Do not vary
Measurement	By reference to underlying items	Building block approach	
Presentation of measurement changes	Consistent with underlying items	Profit or loss	Profit or loss or OCI, following general requirements

Source: EY Global Insurance Center



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Presentation Proposals

Insurance Contract Revenue and Expenses

Revenue and expenses

- ▶ An entity shall present revenue relating to the insurance contracts it issues in the statement of profit or loss and other comprehensive income
- ▶ Insurance contract revenue shall depict the transfer of promised services arising from the insurance contract in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services



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Presentation Proposals

Insurance Contract Revenue and Expenses

Revenue and expenses (cont.)

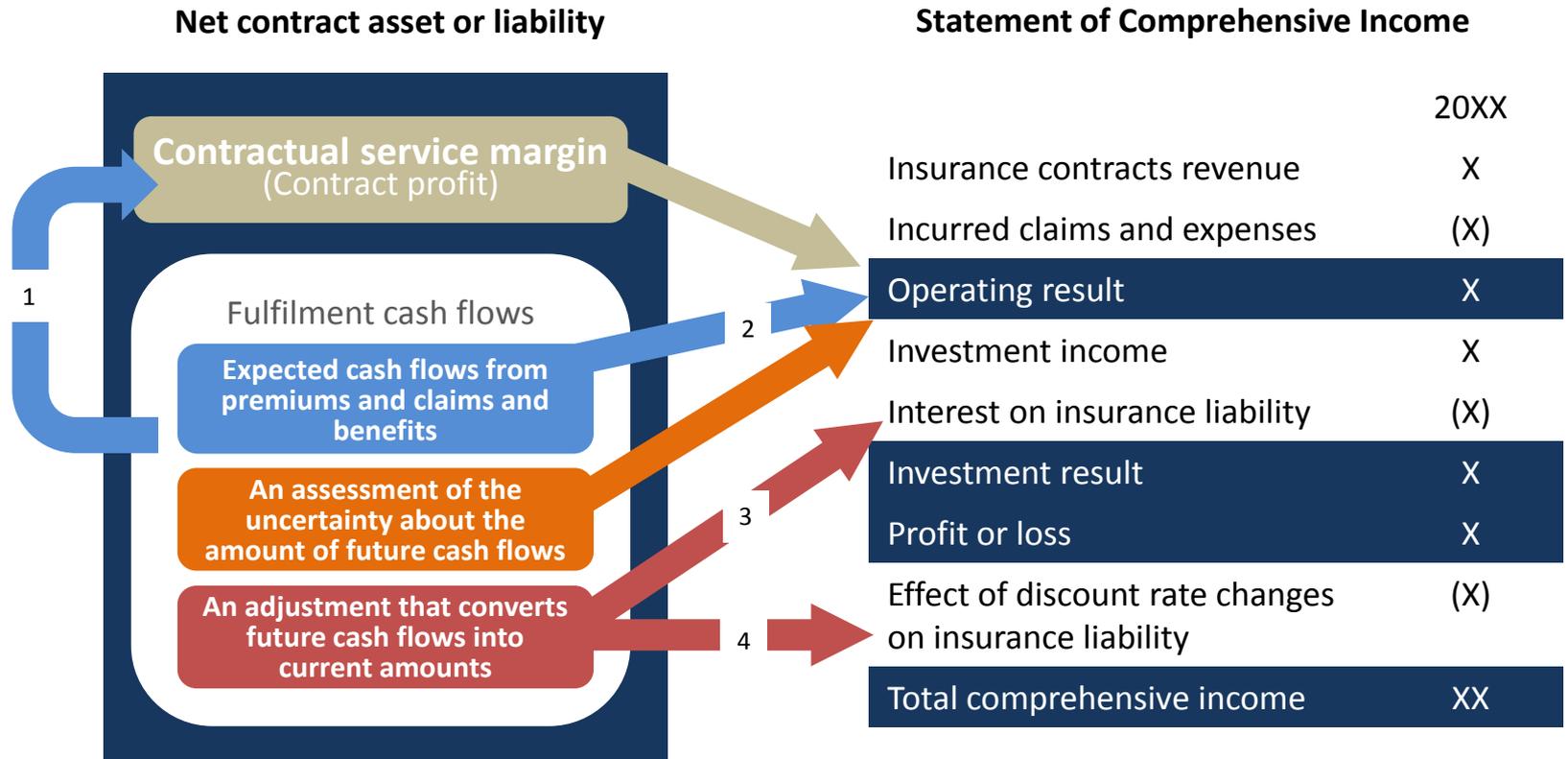
- ▶ An entity shall present incurred claims and other expenses relating to an insurance contract it issues in the statement of profit or loss and other comprehensive income
- ▶ Insurance contract revenue and incurred claims presented in the statement of profit or loss and other comprehensive income shall exclude any investment components that have not been separated



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Presentation Proposals

Insurance Contract Revenue and Expenses



Source: IASB website (Work plan for IFRS: Insurance Contracts)



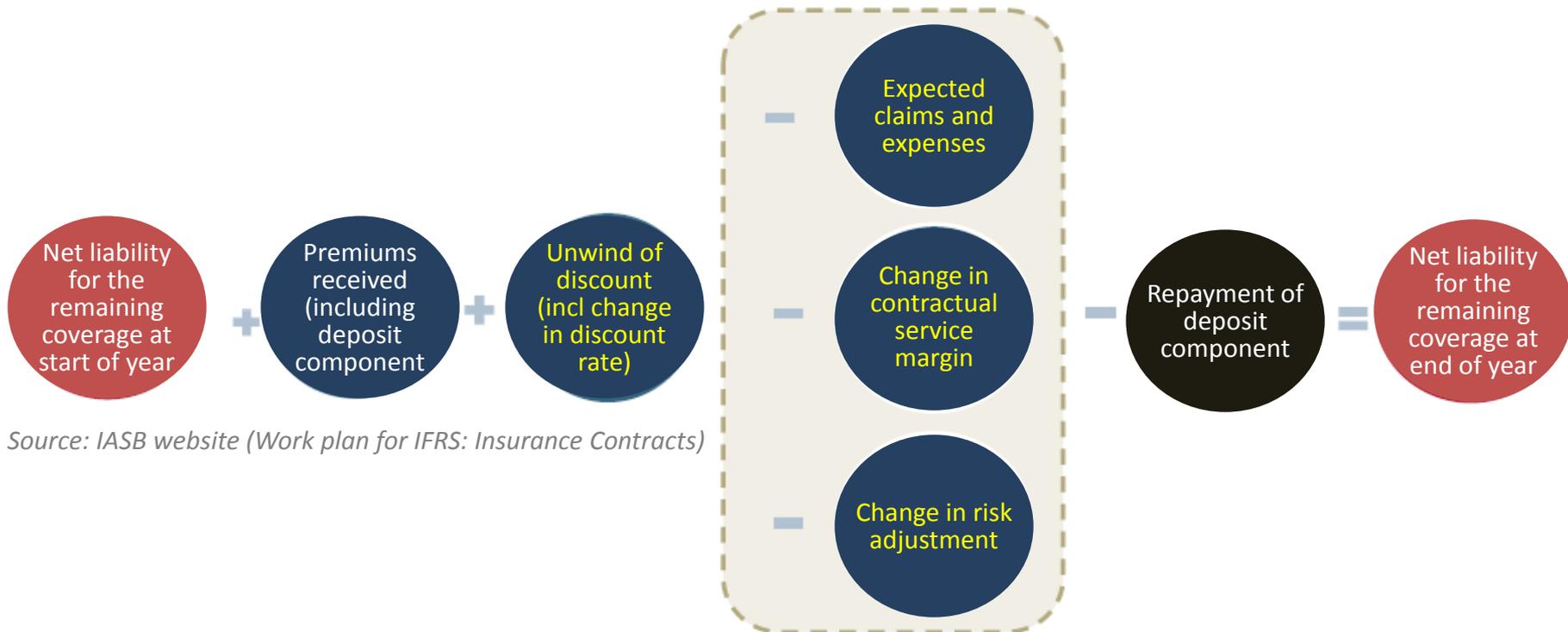
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Presentation Proposals

Insurance Contract Revenue and Expenses

The illustration below shows how revenue relates to changes in the measurement of the insurance contract:

Insurance contract revenue

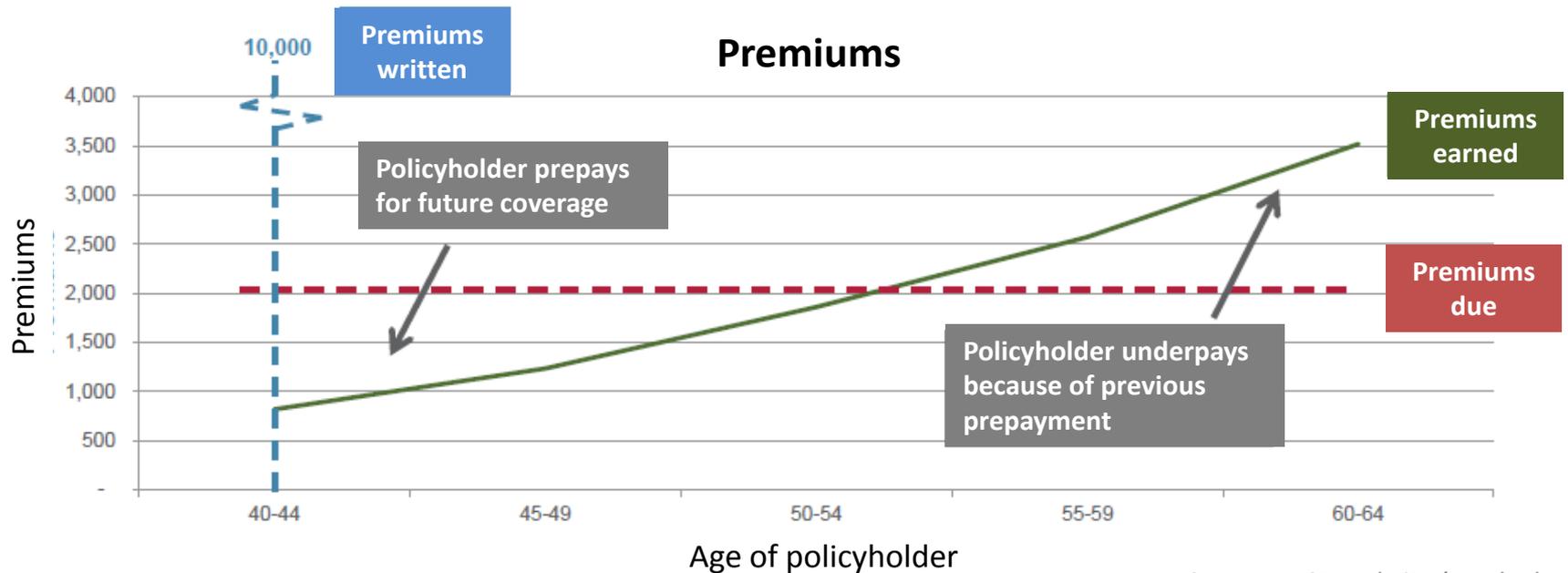


Source: IASB website (Work plan for IFRS: Insurance Contracts)



Presentation Proposals

Insurance Contract Revenue and Expenses



Assumptions:

- ▶ Portfolio of term life contracts issued to 40-year-olds
- ▶ Expected claims/benefits are 10,000; premiums are due 2,000 each five-year period
- ▶ Ignores premiums “allocated” to the margins, payment of acquisition costs and payment of maintenance and benefits expense
- ▶ Assumes no lapses, no discounting and no investment component

Source: IASB website (Work plan for IFRS: Insurance Contracts)



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Presentation Proposals

Interest Expense

- ▶ Changes in the liability discount rate are generally presented directly in OCI rather than in profit or loss:
 - ▶ Specific provisions for certain types of contracts with participating features
- ▶ Interest expense in profit or loss is based on discount rate locked in at inception
- ▶ Amounts recorded in OCI will represent the impacts of changes in the discount rate between contract inception and the current rate:
 - ▶ Reversal of amounts recognized in OCI occurs over time. However, any remaining balance is completely recycled upon derecognition of a contract.



Approach to Transition

Applying the New Standard

- ▶ The insurers shall retrospectively apply the new standard at the beginning of the earliest period presented unless it is impracticable to do so
 - ▶ The effective date is around three years after issuance of the final standard.
 - ▶ Entities will be required to restate comparative financial statements.
 - ▶ Early adoption will be permitted.



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Approach to Transition

Applying the New Standard

(cont.)

- ▶ Include contractual service margin on transition (retrospective application with simplification to the extent impracticable)
- ▶ Discount rate calculated in accordance with practical expedient
- ▶ Insurers will be permitted to re-designate eligible financial assets under the Fair Value Option



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UPDATES ON THE IASB'S RE-DELIBERATIONS



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Unlocking the Contractual Service Margin

Re-deliberations

Tentative conclusions:

- ▶ Confirmed the ED 2013 proposal on unlocking of contractual service margin (CSM)
- ▶ Previous losses recognized in profit or loss should be reversed before the contractual service margin is reinstated
- ▶ Contractual service margin shall be unlocked for subsequent changes in the risk adjustment that relate to future coverage and other services
- ▶ Changes in risk adjustment relating to services provided in current and past periods should be recognized immediately in profit or loss
- ▶ Use of locked-in interest rates for both the accretion of interest to, and the unlocking of, the CSM



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Participating Contracts

Re-deliberations

For discussion:

- ▶ How to measure the fulfillment cash flows
- ▶ Whether to unlock the CSM for an entity's share in the underlying items
- ▶ How to recognize the CSM in profit or loss
- ▶ Where to recognize changes in expected future cash flows and the effects of options and guarantees
- ▶ How to present the interest expense on the insurance liability in profit or loss
- ▶ How to determine interest expense when the effect of changes in interest rates will be presented in Other comprehensive income



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Participating Contracts

Re-deliberations

Tentative conclusions:

- ▶ Starting point is the building block model but adaptation is necessary
- ▶ Determining interest expense in profit or loss on participating contracts should be aligned with how returns on underlying items are presented



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Insurance Contract Revenue

Re-deliberations

Tentative conclusions:

- ▶ An entity should present in its statement of comprehensive income insurance contracts revenue and incurred expenses (volume information) for all insurance contracts
- ▶ Revenue figure would:
 - ▶ represent an allocation of the total premium over the coverage period of the contract on the basis of the transfer of services
 - ▶ exclude the investment component



Insurance Contract Revenue

Re-deliberations

Tentative conclusions (cont.):

- ▶ Prohibits entities from including other volume information (e.g., premiums due or premiums written) within the statement of comprehensive income which could be misleading
- ▶ Under the premium allocation approach, the entity should recognize revenue:
 - ▶ On the basis of the passage of time
 - ▶ Unless expected pattern of release of risk differs significantly from the passage of time, then on the basis of the expected timing of incurred claims and benefits



Insurance Contract Revenue

Re-deliberations

Tentative conclusions (cont.):

- ▶ Disclosures supporting insurance contract revenue:
 - ▶ A reconciliation of the opening and closing balance of the components of the insurance contract asset or liability
 - ▶ A reconciliation from the premiums received in the period to the insurance contract revenue in the period
 - ▶ The inputs used when determining the insurance contract revenue that is recognized in the period
 - ▶ The effect of the insurance contracts that are initially recognized in the period on the amounts that are recognized in the statement of financial position



Use of Other Comprehensive Income

Re-deliberations

Tentative conclusions:

- ▶ Accounting policy choice whether to present the effect of changes in discount rates in profit or loss or in OCI, is subject to further guidance on:
 - ▶ Entities applying the same accounting policy to groups of similar portfolios (e.g., when are portfolios similar)
 - ▶ Sufficient rigor about when entities could change accounting policies based on International Accounting Standard (IAS) 8, *Accounting Policies, Changes in Accounting Estimates and Errors*; no need to expand the IAS 8 requirements



Approach to the Transition

Re-deliberations

Tentative conclusions:

- ▶ If retrospective application of the Standard is impracticable, an entity should apply the simplified approach proposed in the 2013 ED with the following modification.
 - ▶ Instead of estimating the risk adjustment at the date of initial recognition as the risk adjustment at the beginning of the earliest period presented, an entity should estimate the risk adjustment at the date of initial recognition by adjusting the risk adjustment at the beginning of the earliest period presented by the assumed release of the risk before the beginning of the earliest period presented



Approach to the Transition

Re-deliberations

Tentative conclusions (cont.):

- ▶ If the simplified approach is impracticable, an entity should apply a “fair value approach” in which the entity should:
 - ▶ Determine the CSM at the beginning of the earliest period presented as the difference between the fair value of the insurance contract at that date and the fulfilment cash flows measured at that date
 - ▶ Determine interest expense in profit or loss, and the related amount of OCI accumulated in equity, by estimating the discount rate at the date of initial recognition using the method in the simplified approach proposed in the 2013 ED



IASB NEXT STEPS



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Next Steps of the IASB

- ▶ The IASB plans to hold its next meeting in November (the topics have not yet been announced)
- ▶ The IASB expects to complete re-deliberations on its insurance contracts proposals in 2014, with the publication of the final standard in 2015



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Thank you



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36

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