International Financial Reporting Standards

Accounting for insurance contracts—IFRS 4

Joint World Bank and IFRS Foundation 'train the trainers' workshop hosted by the ECCB
30 April to 4 May 2012

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

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Introduction

- IFRS 4 applies to insurance contracts issued by any entity, including entities that are not regulated as insurers
- Includes both insurance and reinsurance contracts issued
- Also includes reinsurance contracts held
- It does not address other aspects of accounting by insurers, such as accounting for financial assets

Definition
Insurance contract

- Under an **insurance contract**, one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder
- Some contracts having the legal form of insurance may not meet that definition
- Insurance contracts transfer insurance risks (rather than only financial risks)

Definition

Insurance contract continued

- Significant insurance risk
  - significant additional benefits in any scenario (that has commercial substance)
  - not a percentage test
  - contract by contract
- Unbundling a deposit component
- Embedded derivatives

Continuing previous accounting

- IFRS 4 permits insurers to retain most aspects of their previous accounting for insurance contracts
- This avoids disruption while the IASB works on a comprehensive review of accounting for insurance contracts
- The nature and extent of judgements and estimates will, therefore, depend largely on that previous accounting
- Typically this will involve estimates of uncertain cash flows

Unbundling deposit component

Can measure deposit component separately?

NO

MUST NOT unbundle

YES

All rights and obligations recognised?

YES

MAY unbundle

NO

MUST unbundle

Embedded derivatives

- IFRS 9 requires fair value measurement for many embedded derivatives
- IFRS 4 exempts embedded derivatives that:
  - are themselves an insurance contract (specific disclosure required); or
  - are an option to surrender insurance contract for fixed amount

Recognition and measurement

IAS 8 Hierarchy

- Criteria to use in developing accounting policy in absence of specific IFRS guidance
- Exempt under IFRS 4 for insurance contracts issued, and reinsurance contracts held
- But
    - may not change policy unless result is more relevant and reliable
    - may continue existing practice, but not introduce them

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Recognition and measurement

Liability adequacy test

- Use existing test if minimum requirements met:
  - consider current estimates of all contractual cash flows, including embedded options and guarantees
  - recognise any loss immediately in profit or loss
- Otherwise test using provisions standard (IAS 37)

Recognition and measurement

Continue, but may not introduce

- Non-discounting of insurance liabilities
- Off-market measurement of contractual rights to investment management fees
- Non-uniform accounting policies for insurance liabilities of subsidiaries
- Excessive prudence
- Future investment spreads (rebuttable presumption)

DPF's

DPF = Discretionary Participation Features

Contractual right to additional benefits:

- likely to be significant portion of total benefits
- amount or timing contractually at the discretion of the issuer, and
- contractually based on:
    - performance of specified contracts
    - returns on specified assets, or
    - profit or loss

Insurance contracts with DPF

- Guaranteed element
  - policyholder has unconditional right
  - must classify as liability
- Discretionary participation feature
  - may classify as liability, equity or split
  - do not show as mezzanine

Investment contracts with DPF

- May classify whole contract as liability
  - if so, apply liability adequacy test
- May classify part or all of DPF in equity
  - reported liability not less than IAS 39 measurement of guaranteed element

Judgements and estimates

- Determining whether contracts with the legal form of an insurance contract are insurance contracts as defined in IFRS 4

Insurance ‘models’

- Current current
- Current current with discretionary reserving
- Cost cost with OCI
- Cost cost

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Accounting for insurance contracts IFRS 4 Phase II

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Project objective

Improve comparability in the accounting for insurance contracts through:

- coherent, principles-based framework for all types of insurance contracts (no need for ‘add-on’ rules)
- transparent reporting of changes in insurance contract liability
- transparent reporting of economic value of embedded options and guarantees

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Urgent need for change

IFRS 4

- exempts insurers from developing relevant and reliable accounting policies
- wide range of accounting for different types of contracts
- inconsistent application across jurisdictions
- exempts requirement for uniform accounting policies across a group

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What are we trying to do?

Updated measurement of insurance contract liabilities that captures all features of the contract

Disclosures about inherent risk and uncertainty

Presentation that gives information about drivers of performance

Building block approach

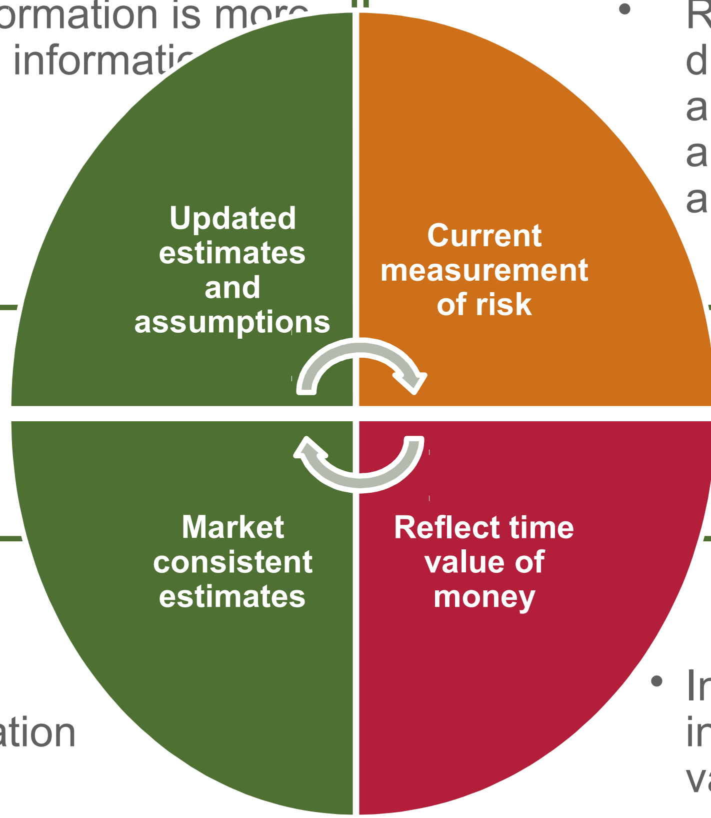
Total insurance liability

Residual margin	Contract profit (reported over the life of the contract)
Risk adjustment	An assessment of the difference between an uncertain liability and a liability whose amount is certain
Time value of money	An adjustment that reflects the time value of money
Cash flows	The amounts the insurer expects to collect from premiums and pay out for claims, benefits and expenses, estimated using up-to-date information

The model: Key features

- New updated information is more relevant than old informati

- Reflects the difference between an uncertain liability and a liability whose amount is certain



- Reflects best available information

- Investors are not indifferent to time value of money

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Which cash flows?

Residual margin
Risk adjustment
Time value of money
Cash flows

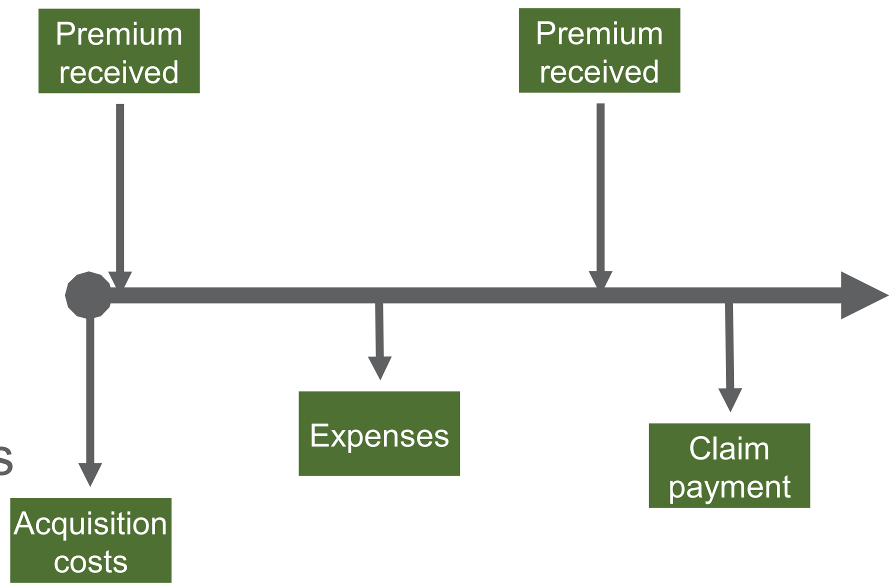
An explicit, unbiased and probability-weighted estimate of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract

✓ Confirmed use of expected value of cash flows incurred, considering all relevant information

+ Add guidance that not all possible scenarios need to be identified and quantified

Which cash flows? continued

Recognition point:
Contract starts when coverage period begins



Contract boundary:
Contract ends when:

- Not required to provide coverage
- Can reprice to reflect risks of policyholder
- When insurer can reprice to reflect risk of portfolio

Included in cash flows:
All direct costs of *originating* and all directly attributable costs incurred in *fulfilling* a portfolio of insurance contracts

Time value of money

Residual margin

Risk adjustment

Time value of money

Cash flows

A discount rate that adjusts cash flows for the time value of money

✓ Confirm discount rate:
- reflect only characteristics of the insurance contract liability
- current and updated each reporting period

\+ Guidance on determining the discount rate
- 'top-down' and 'bottom-up'
- remove any factors not relevant to the liability

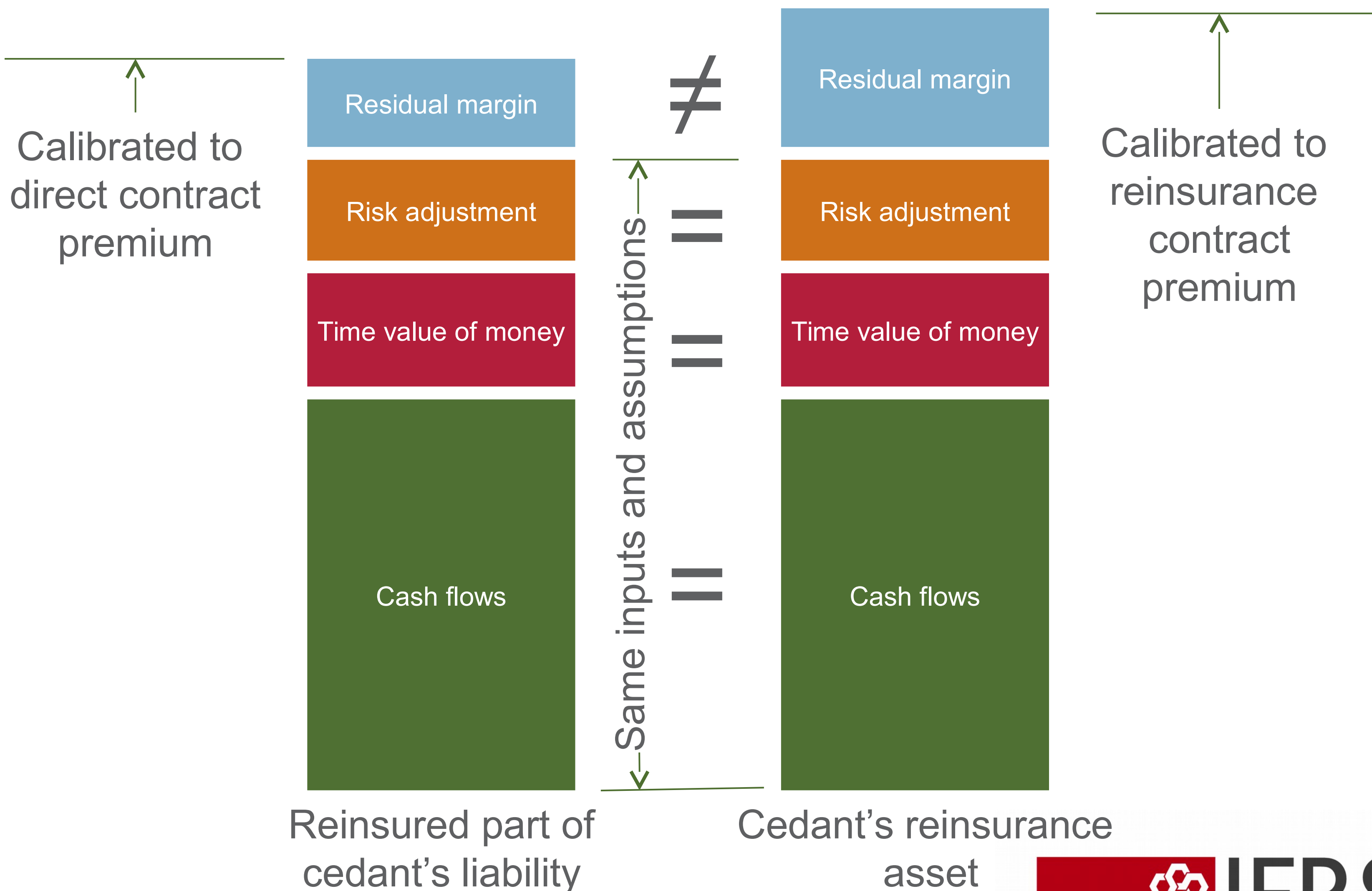
Residual margin

Residual margin
Risk adjustment
Time value of money
Cash flows

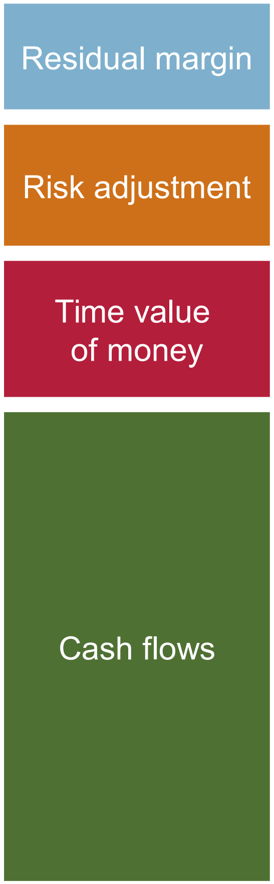
A residual margin that eliminates any gain at inception of the contract

- ✓ Confirm no gain at inception
- Adjust for changes in estimates of cash flows
- Adjustments made prospectively

Reinsurance assets

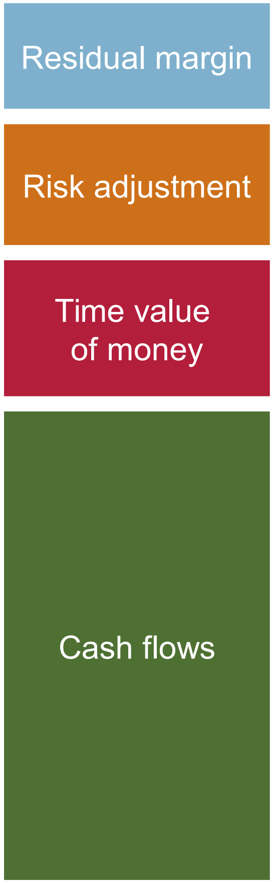


Reinsurance assets



- ED: symmetry with underlying liability
  - losses at inception recognised over contract term
  - gains at inception recognised immediately
- Tentative decisions:
  - use same estimates for reinsurance asset and underlying direct insurance liability
  - gains recognised over contract term
  - losses recognised immediately if for past events, otherwise deferred

Short duration contracts



- Liability for remaining coverage reduced over coverage period
- Onerous contract test when facts and circumstances indicate
- Claims liability discounted if material
- Eligible for this approach if outcome reasonably approximates BBA
  - 12 month practical expedient
  - approach is permitted, not required

Presentation: remaining questions

- Provide information about premiums, claims and expenses
- Still to conclude:
  - level of disaggregation on the income statement
  - separately disclose short and long term contracts
  - treatment of deposits in premium income
  - presentation in other comprehensive income

Next steps

- Complete remaining topics
- Assess whether any differences between IASB and FASB can be reconciled
- Review draft or re-expose (early 2012)

Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.