FRC Roundtable on IASB Revised ED *Insurance Contracts*

2 October 2013

Agenda

- Chairman's Introductory Remarks
- IASB Revised ED Proposals
- Preparer Perspective
- Auditor Perspective
- FRC DCL Summary
- Questions, Comments, Discussion

Chairman's Introductory Remarks

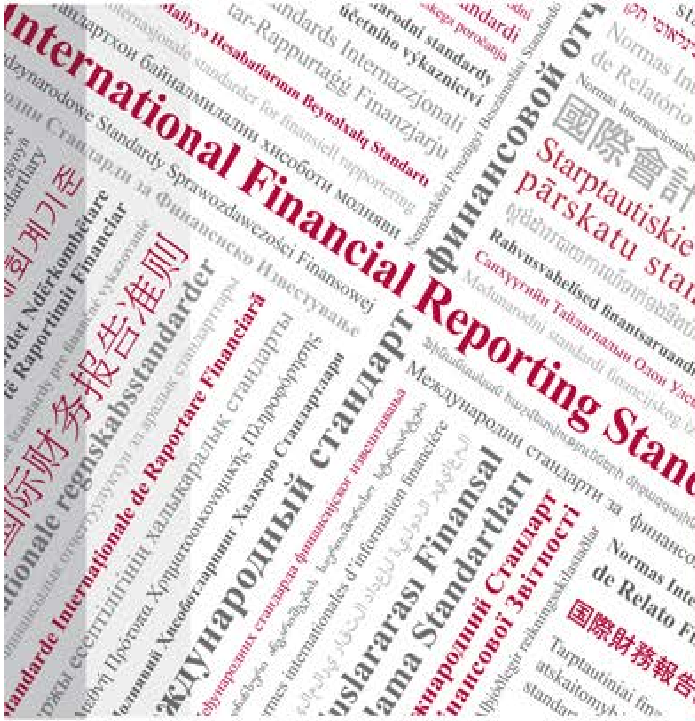
Roger Marshall

IASB Proposals

Stephen Cooper

IFRS Foundation

International Financial Reporting Standards



Revised Exposure Draft *Insurance Contracts*

FRC Outreach Event on Insurance Accounting, 2 October 2013

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

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Context for revised exposure draft: No comprehensive IFRS today

IFRS 4 *Insurance Contracts* is an interim Standard

- Permits continuation of a wide variety of accounting models
- Requires disclosures to enhance comparability and to understand reported amounts
- Does not facilitate transparency

We have listened and responded to your concerns

- Improves representation of some aspects
- Introduces practical accommodations to conceptual approaches
- Provides additional clarification and guidance

Revised Exposure Draft (ED) next step toward final Standard

- Builds on previous consultations
- Seeks feedback on changes to previous proposals
- Focuses on operational and reporting complexity of revised proposals

How our proposals improve accounting

Comparable accounting for all insurance contracts by all entities

- Estimates updated to reflect current market-based information
- Measurement of insurance contract reflects discounting where significant
- Discount rates reflect characteristics of the cash flows of the contract
- Measurement reflects information about full range of possible outcomes

More transparent information

- Insight on how entity manages assets and liabilities
- Insight into effect of options and guarantees
- Better understanding of risk from insurance contracts

IASB seeks feedback on targeted aspects

Measurement proposals

- Changes in estimates relating to expected contract profit for providing coverage recognised over remaining period (**unlocking**)
- Measurement and presentation exception when no economic mismatch is possible (**mirroring**)

Presentation proposals

- Align to presentation of **revenue** required for other types of contracts with customers
- Interest expense is amortised cost-based in profit or loss, current value-based on balance sheet (**OCI proposals**)

Approach to transition

- Apply Standard retrospectively if practicable, or with specified simplifications if not practicable

Balancing benefits against complexity

Better reflection of the economics of the contracts, simplifications where appropriate

Costs of greater operational complexity for preparers and of understanding more complex information for users

What we have heard so far

Measurement proposals

- Unlocking: generally supported, some questions about mechanics
- Mirroring: conceptual acceptance, but significant concerns about whether proposals can be made workable

Presentation proposals

- Revenue: increasing acceptance of conceptual merits, doubts about usefulness of information, some prefer 2010 proposals
- OCI proposals: some see benefits of amortised cost and current information, extensive concerns about accounting mismatches

Approach to transition

- Transition: general acceptance and acknowledgement that new proposals are an improvement

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Timetable

20 June 2013
Revised Exposure Draft

25 Oct 2013
Comment letter deadline

H1 2014
Board debates issues

Early 2015
Issue IFRS

Effective date
Approx 3 years after Standard finalised

For more information…

Stay up to date

- Visit our website:
  - www.ifrs.org
  - go.ifrs.org/insurance_contracts
- Sign up for our email alert

Ask questions or share your views

- Email us: insurancecontracts@ifrs.org

Resources on IASB website

- IASB Update
- Project podcasts and webcasts
- Snapshot
- Feedback statement
- Investor resources
- High level summary of project

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Preparer Perspective

Hugh Francis

Aviva

FRC Outreach Event

IFRS Phase 2 - An insurance company perspective

October 2013

Hugh Francis

Director of External Reporting Developments, Aviva Plc

AVIVA

History – 1997 to 2013, what's changed!!!

What we have been seeking (from 2006 EP)

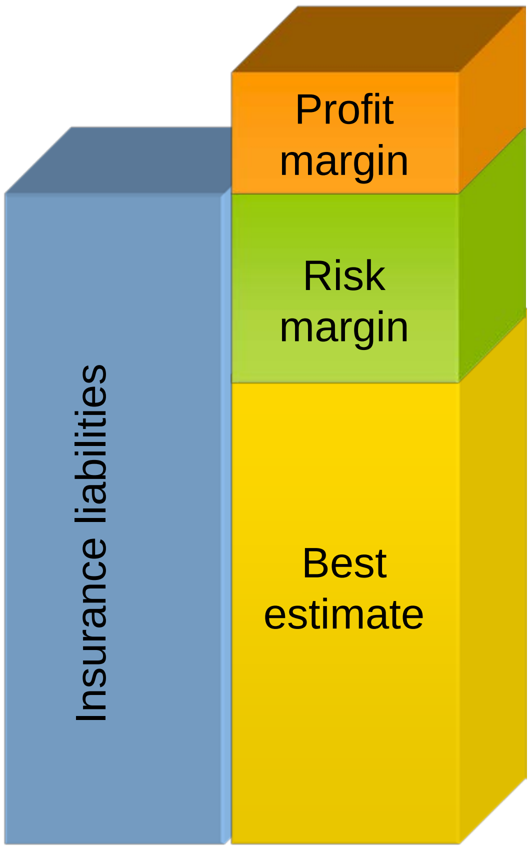
CFO FORUM

What are we proposing?

A single model for life and non-life

Reflect the insurance business model	• Profit recognised in line with release from risk
Market consistent valuation of liabilities	• Present value of future cash flows with allowance for risk and uncertainty • Risk free discount allowing for liquidity, with recognition of options and guarantees
Reflect how insurance companies manage risk	• Liabilities measured on a portfolio basis reflecting policy-holder behaviour • Assets and liabilities measured on a consistent basis

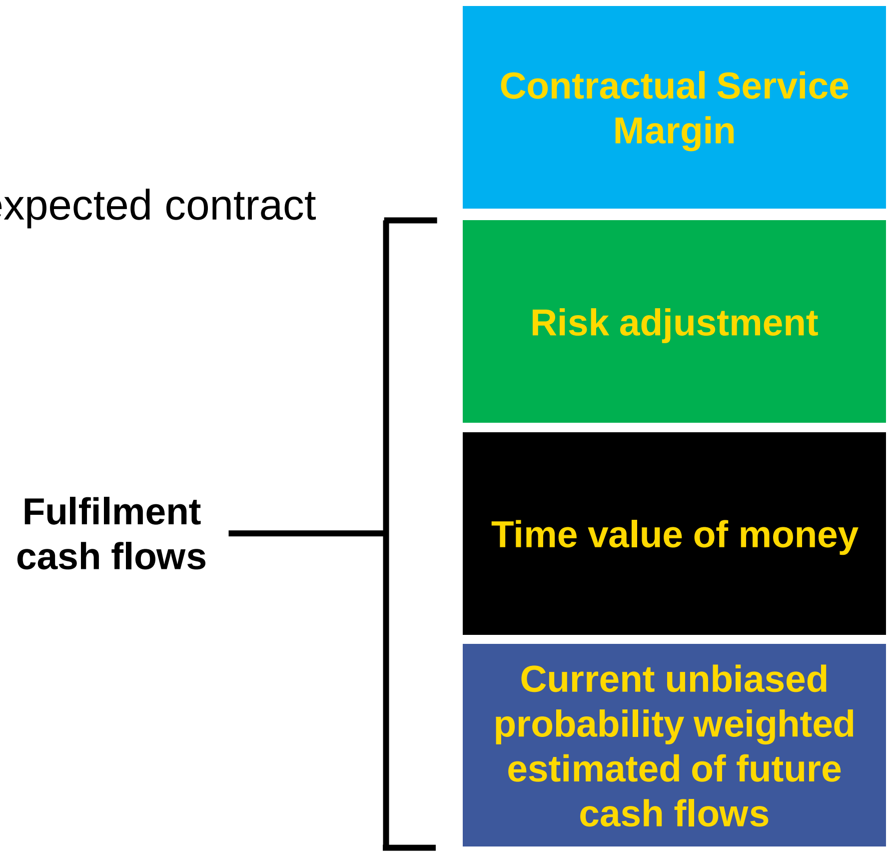
European Industry perspective of insurance liabilities (2006)



- Market consistent fulfilment cost
- Active measurement of insurance liabilities
- No "day one" gain, but recognises profit in line with release from risk
- Insurance liabilities represents best estimate plus margin for risk and uncertainty
- Profit margin should be presented separately within the liabilities section of the balance sheet

Overview of IFRS 4 Phase II model

- **IFRS 4 Phase II building block model**
  - o Best estimate of expected future cash flows
  - o Discounted for the time value of money
  - o Risk adjustment to reflect uncertainty
  - o Contractual service margin represents expected contract profit



Key developments

- **Timeline:** IASB has indicated the following tentative timeline:
  - Comment period closes – 25 October 2013
  - IASB considers comments – 2014
  - IASB issues final standard – 2015
  - Effective date – 1 January 2018; not (yet) aligned with IFRS 9

- **Overall Impact:** New standard will significantly impact on:
  - Measurement of insurance contract liabilities
  - The profit recognition profile in the income statement
  - Presentation of premiums in the P&L
  - Complexity and cost

Key developments

- Revised insurance exposure draft (ED) issued on 20 June seeking comments **only** on the 5 main areas of change:
  1. Use of OCI
  2. Unlocking Contractual Service Margin (previously Residual margin)
  3. Contracts linked to underlying (previously Participating contracts)
  4. Presentation
  5. Transition

- Industry is assessing implications of the ED.
- Proposals are complex and require significant analysis and discussion.
- The IASB has made a number of improvements since the 2010 ED

 - Unlocking CSM, Discount rate, Premium Allocation Approach, Transition, ability to use OCI

- **But, significant changes are still needed**.

Main issues to be resolved

AVIVA

- *Inconsistency between measurement of assets and liabilities* – mandatory requirement to reflect all changes in discount rates for liabilities in OCI and no option to apply fair value through P&L; IFRS 9 for assets restricts OCI to simple debt securities only – accounting mismatches will arise for other assets (loans, real estate, derivatives); no option to apply fair value through P&L, even not when that provides better matching (e.g. with derivatives)

- *Participating and unit-linked contracts* – "mirroring" does not result in appropriate profit recognition pattern; mechanics are unclear and highly complex, resulting in bifurcation of cash flows of individual contracts; limited unlocking of the contractual service margin

- *Income Statement Presentation* – premiums and claims in the P&L on a "notional" earned premium basis which is complex and of little relevance to users

- *Proposals are overly complex* – e.g. accretion of interest on residual margin, bifurcation of cash flows; significant implementation time and cost, disclosures and confidence level

Key concerns

Mandatory OCI *– particularly for closely matched portfolios (annuities) and General Insurance – no one size fits all – need to reflect characteristics of liabilities, asset liability management and provide meaningful information to users*

Unlocked contractual service margin, mirroring & bifurcation of cash flows *– Participating contracts – need for alternative approach*

Untried and untested model *– field tests and further testing*

Effective date with IFRS 9

Areas of complexity - Bifurcation of cash-flows, Unit of account, Accretion of interest, Earned premium for life business, Disclosures including confidence level

Other areas - Risk adjustment/CSM, Reversal of prior losses. Options and guarantees, Policyholder taxes, Unbundling, Disclosure including confidence levels

Conclusion

IFRS Phase II is nearly here

As preparers we need to step back and consider the proposals holistically

The key questions we are asking:

Do the proposals reflect our business and meet the needs of users ?

Are they a suitable basis for performance reporting

Is Phase II a step forward or a missed opportunity?

Phase II is critical to the future of insurance industry reporting and represents fundamental change.

Auditor Perspective

Francesco Nagari

Deloitte

Deloitte.

IFRS 4 Phase II
An auditor's perspective

Squaring the accounting circle: current value balance sheet and amortised cost earnings

2 October 2013

Francesco Nagari
Deloitte Global IFRS Insurance Lead Partner

Audit. Tax. Consulting. Corporate Finance.

Agenda

- The measurement proposals
  - The unlocking of the Contractual Service Margin
  - The mirroring approach
- The OCI solution
- The new insurance revenue amount
- The transition provisions

Auditing the emergence of insurance profit

The unlocking of the contractual service margin (CSM) is a major improvement

- There is a lot more than a name change
  - Recalibration principle
  - Transparency
  - Predictive value

- Areas of concern
  - Coverage period vs. contract life
  - Restrictions on assumptions that can unlock
  - Removing the risk adjustment from the unlocking

- Audit of the CSM
  - One portfolio, many CSM
  - The implicit definition of a CSM cohort
  - Judgment on the earning pattern
  - An implicit test on expected cash flows being a statistical mean

- Challenges in the audit of the unlocked CSM
  - Not any change in assumption unlocks
  - Unlocking under the mirroring approach
  - Accretion of interest
  - Reinsurance assets: positive and negative CSM

Auditing the emergence of insurance profit

The challenges of the mirroring approach and its potential flaws

- Participating contracts cut across insurance and financial instruments
- Economically matched asset/liability cash flows – earnings or balance sheet emphasis?
- Mirroring is well intended but it comes with practical issues
  - Scope of mirroring is unclear
  - Three different sub-sets of cash flows
  - Three different accounting treatments
  - Integrity of the balance sheet is compromised

- A number of flaws exist
  - Maximisation of the fixed element clashes with pricing and product design
  - Accounting for guarantees creates equations where only a "best fit" approach works
  - Initial measurement may create different CSM levels for identical products depending on the underlying item value
  - Application to underlying items that are not an individual asset (e.g. mortality surplus participation) is difficult
  - Cash flow interdependency may still require a full BBA calculation restricting the mirroring to presentation only

Squaring the accounting circle – the OCI solution

A good first step in the right direction, but not quite there yet!

- OCI could deliver a more faithful representation of insurers' earnings
- There are changes driven by interest rates fluctuations that unwind over time

- There are issues though:
  - Mandatory nature of OCI for insurance contracts
  - Incomplete alignment with IFRS 9 OCI solution

- Hedge accounting solutions for interest rate risk have not been contemplated
- Removing mandatory nature appears to be a possible solution

Life insurance is a widget – auditing the new revenue amount

Is this really what users want?

- The proposal would present a number of issues
  - Is the revenue figure consistent with the accounting of the contract as a bundle of rights and obligations?
  - Does it tie to the customer consideration?
  - Can insurance revenue be negative?
  - Is the disaggregation of deposit components practicable?
  - Does it inform users about sales of insurance contracts?
  - Is it a good basis for determining the gross margin from insurance contracts?
- Auditing this amount would not be straightforward and it would add to the cost against which benefits would be measured
- Retaining the summarised margin may be a more appealing route

Audit of the transition process

- The new transition provisions are a substantial improvement compared to the 2010 proposals
- The pragmatic solutions for impracticable restatements of CSM and OCI are clear
- A solid audit trail should emerge
- The FASB proposal on portfolio definition at transition should be adopted in IFRS

- The issue on the “decoupling” of IFRS 9 and the new IFRS for insurance contracts is critical
- Alignment should be sought with the possibility of early adoption effectively playing in favour of areas where IFRS 9 would be implemented sooner

Summary of FRC's Draft Comment Letter (DCL)

Seema Jamil-O'Neill

FRC

FRC's DCL

- Issued mid-September 2013
- Highlights initial views and areas of concern
- Looking for views and feedback
- Broadly supportive of the IASB's measurement model…

But some concerns

FRC's DCL cont…

- **Mirroring approach in the ED is problematic**
  - Decomposition of cash flows that are closely linked and part of a single contract
  - Decomposition and separate measurement of cash flows is operationally complex
  - May lead to different answers depending on how calculation performed

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FRC's DCL cont…

- **Mandatory presentation of insurance liabilities through OCI**
  - Significant impact for insurance companies
  - Create accounting mismatches and hardcode them into accounting for insurance contracts
  - Increase complexity in financial statements – impact on understandability
  - Incentivise insurers holding assets that can be held at FV-OCI (e.g. corporate debt) over those compulsorily required to be FV-PL (e.g. equities)

FRC's DCL cont…

- **Accretion of interest on CSM at locked in rates**
  - Inconsistent as all other elements at current rates
  - Operationally complex to maintain cohorts for this purpose

- **Significant change for insurance companies**
  - IT and other system changes required
  - Sufficient implementation time but permit early adoption
  - Review draft on website to allow implementation issues to be ironed out

FRC's DCL
What it doesn't cover

- **Solution for participating contracts**
  - Industry proposal – "*floating contractual service margin*"

Pros

- Reflects the economics of with-profits business on the balance sheet
- Permits current value measurement of contracts on an on-going basis
- Recognition of returns on contracts in line with service provision

Cons

- Can result in significant variations in the CSM

FRC's DCL
What it doesn't cover

- **Unlocking the risk margin**
  - Currently ED proposes any changes in risk margin impacts the Profit or Loss
  - Argument – changes in risk margin should be taken to CSM?
    - Consistent with overall model in the ED?
    - Approach permitted for changes in future cash flows

    But

    - Is it more useful for users to see changes in risk recognised in Profit or Loss?

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FRC's DCL
What it doesn't cover

- **Interaction between standard on insurance contracts with IFRS 9**
  - How many measurement and presentation categories in IFRS 9?
  - Implementation date?
  - Transition – timing and provisions

FRC's DCL

- Comment by 10 October 2013

- Due Process – Accounting Council review
  – C&S Committee Review
  – Response Submitted

Comments, Questions, Discussion

Reporting performance
on insurance contracts

- OCI
- FV-PL

Mirroring approach

- Operational?
- Alternatives?

Unlocking the risk margin

Interaction with IFRS 9

Accreting interest on CSM

Effective date and transition

Costs v Benefits

Other