

# IFRS insurance contracts: Summary of feedback on the 2013 exposure draft

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This market update gives a summary of feedback received by the IASB on its 2013 exposure draft regarding insurance contracts and recent discussions by the board.

## INTRODUCTION

In June 2013 the International Accounting Standards Board (IASB) published a new exposure draft (ED) as part of Phase 2 of the project to develop a comprehensive accounting standard for insurance contracts (IFRS4). This follows a first ED released in 2010.

The 2013 ED has the aim to finalise the IFRS4 project, and therefore the IASB has decided to limit the topics where it was looking for feedback to only five main items:

- Adjustment of the contractual service margin (CSM)
- Treatment of the contract that requires the entity to hold underlying items and specify a link to returns on those items
- Presentation of insurance contract revenue and expense
- Interest expense in profit or loss
- Transition requirements

In addition, IASB was looking for feedback on the practicability of the application of the new standards and whether the benefits outweigh the costs of preparing reports based on the new standard.

A summary of the IASB proposals can be found in our paper "[IFRS Insurance Contracts Summary 2013 Exposure Draft](#)" of September 2013.

## SUMMARY OF FEEDBACK LETTERS

In total, 194 comment letters were received. Many believe that the new proposal is an improvement over the 2010 version, with most of the concerns receiving satisfactory treatment. The main topics that received support are:

- Contract boundaries (both the recognition point and boundary where the cash flows are considered to be outside the boundary, i.e., after the entity is able to re-price the contract)

- Change in scope for some cash flows, in particular, inclusion of an allocation of overhead expenses and clarification that all directly attributable cash flows should be included (for both successful and unsuccessful efforts)
- Clarification that both "top-down" and "bottom-up" approaches can be used to determine the discount rate
- Removal of the limitations for the risk-adjustment techniques
- Unlocking of the contractual service margin
- Revision of the premium allocation approach
- Revision of the eligibility criteria for simplifications like exception from discounting and requirements to assess if the contract is onerous
- Requirement to apply the standard retrospectively if practicable

However, many comment letters expressed strong concerns with regard to:

### Complexity

- Bifurcation of cash flows (e.g. for the mirroring approach)
- Need to track changes that are recognised through the contractual service margin, P&L and other comprehensive income (OCI)
- Use of locked in discount rates
- Determination of information that in practice is not being used by the management, like the separation of investment components

### Extent of accounting mismatches

- Use of OCI for changes in the insurance contract liability

### Treatment of participating contracts

- Significant concerns about the use of the mirroring approach, suggesting the use of the building blocks approach instead

## FEEDBACK ON MAIN ITEMS

### Unlocking of CSM

Most respondents supported the proposal. However, many have indicated that this may result in additional operational complexity related to the interaction between the locked in discount rate and unlocking of CSM. Due to the difference in views on what exactly is “unearned profit,” respondents proposed various suggestions as to how the mechanism of unlocking should be modified. In particular, main suggestions included:

- Unlocking for changes in risk adjustment
- Reversal of losses: for onerous contracts, favourable changes in estimates should first recover previously recognised losses
- Unlocking for additional changes in estimates, including changes in investment assumptions
- Unlocking for the change in value of options and guarantees

### Mirroring exception

Many respondents sympathised with IASB intentions to reduce accounting mismatch for some participating contracts. However, there was limited support for the current proposal. The proposal was widely criticised for its complexity, potential workability and lack of clearness in terms of its scope and implementation. The major concerns are:

- Operational complexity (cash-flow bifurcation)
- Limited scope
- Lack of reflection of the participating contracts’ economics

There is some doubt that IASB will be able to resolve the practical difficulties in the application of the mirroring approach. Some suggest that accounting mismatches are better dealt with by consistency of approaches rather than by exceptions.

### Revenue presentation

Many supported the objective of consistent reporting. Many supported the idea that the statement of comprehensive income should have more information than just a margin to make the statement more comparable to other industries.

The major opposition to the proposal comes from the requirement to decompose a deposit component from the insurance contract, as such an investment component is viewed as an integral part of the insurance contract and because of excessive complexity to do so.

Many doubt that the proposal has benefits in terms of measuring insurance activity. As a result, the following alternatives are being proposed by respondents:

- Premiums due
- Written premiums
- Summarised margin approach

### Presentation of interest expense in OCI

Some supported the proposal to present the effect of changes in discount rates in OCI, because this will reduce short-term volatility and it will provide additional transparency about the underwriting result. However, the vast majority opposed the proposal to present changes in discount rate in OCI.

Suggestions varied from changes to the way that OCI would be used to alternatives where OCI would not be used:

- Optional effect of discount rate change in either OCI or P&L
- Expand use of OCI to covering assets
- Alternative proposals (presenting interest expenses using, e.g., a book yield)

### Transition

Most respondents welcomed the proposal. Even though the new proposal will result in extra operational costs, the benefits outweigh these costs. There are some suggestions as to further simplifications:

- Some suggest applying simplifications to all the contracts in force at transition date
- Many suggest determining CSM on transition as the difference between previous GAAP reserves and fulfilment cash flows.

## CONCLUSION

Many basic concepts, such as the building block approach and a need to project liabilities stochastically to value options and guarantees, almost certain will make their way to the final standard. However, there are some issues that were widely criticised by the respondents. For those, IASB may try to adopt a different approach to address the criticism.

### Limitations on unlocking the CSM

In March 2014, the IASB confirmed the principles in the ED on unlocking the CSM, including the fact that favourable changes in onerous contracts should first be used to reverse previous losses. It tentatively decided unanimously, however, that changes in the risk adjustment that relate to future coverage and other future services are to be absorbed by the CSM as well.

### Use of other comprehensive income

IASB also discussed in March whether it should develop an option that would permit entities to present changes in discount rates in either P&L or OCI and apply this on all contracts in a portfolio.

On the one hand, it confirmed the benefits of OCI for separating underwriting results from investing results by forming a bridge between a measurement using locked in rates (P&L) and the current discount rate (fulfilment value). This would also keep reversible changes in long-term contracts out of P&L.

On the other hand, they recognised that in some cases the difficulties in understanding reported information, because of accounting mismatches, might outweigh these benefits.

A majority (13 against 3) therefore tentatively approved the above mentioned optionality. They also tentatively added extra disclosure requirements regarding the components of the total interest rate expense, to allow comparison between entities using a different approach.

### Other items

In the following months, we expect that the IASB will discuss and consider possible changes to:

- Treatment of participating contracts, including the decomposition of cash flows. In our opinion, the decisions taken on the optional use of OCI might eventually also affect the treatment of participating contracts
- Insurance contract revenue
- Discount rates
- Unit of account
- Reinsurance

IASB is planning to issue a final standard in 2015. This means that it will have an effective date as early as 2018. Even though it is not yet completely clear what the final standard will look like, it is clear that insurers should start their planning process. The timing of implementation of both IFRS4 and IFRS9 will be something the board and insurers will need to monitor.

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