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Insurance Accounting Alert

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IASB makes decisions on level of aggregation and the effect of discretion for participating contracts

What you need to know

- A loss for onerous contracts will be recognised only when the Contractual Service Margin (CSM) is negative for a **group** of contracts with similar risks and profitability at inception.
- The CSM could be allocated to profit or loss over time at either the individual contract level or for a group of contracts, provided that doing so meets the objective of recognising the CSM in profit or loss over the coverage period in a way that best reflects the provision of service.
- The level of aggregation for determining onerous contracts or allocation of the CSM will not be impacted by price regulation.
- For participating contracts accounted for under the general model, an entity needs to specify at the start of the contract how it views the effect of discretion and use that specification to distinguish between the effect of changes in market variables and changes in discretion.

Overview

During its January meeting, the International Accounting Standards Board (IASB or the Board) continued its discussions on the new insurance contracts standard (IFRS 4 Phase II). The IASB discussed the level of aggregation to be used for determining the CSM at inception and allocating it over time into profit or loss. The Board also provided clarification on how to distinguish between the effect of market movements and the application of discretion under the general model for participating contracts.

The story so far

The IASB's website provides information about tentative decisions made on the insurance contracts accounting model prior to this meeting, including:

- The cover note for the Board's papers on insurance for the January meeting which contains a summary of progress so far: www.ifrs.org/Meetings/MeetingDocs/IASB/2016/January/AP02-Insurance-contracts.pdf
- Further information on the project and the proposed model: www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Insurance-Contracts.aspx

Level of aggregation

Onerous contracts

Under the IASB's proposed model an entity recognises a positive CSM on inception to recognise the profit expected on contracts over the coverage period. A negative CSM, which arises on onerous contracts, is recognised immediately in profit or loss. The level of aggregation is therefore an important factor in determining whether expected losses on some contracts may be offset against expected gains on the other contracts that are in the same group. The staff noted that previous Board discussions on the level of aggregation resulted in uncertainty around the Board's intent. The staff therefore presented a proposal on the level of aggregation with a fresh perspective. The staff emphasised there is no absolute right answer on the level of aggregation and the aim is to achieve a balance between loss of information about individual contracts that are or have become loss-making against the faithful representation of the effect of grouping contracts.

The Board tentatively decided that a loss for onerous contracts should be recognised only when the contractual service margin is negative for a **group** of contracts, and that a group should comprise contracts that at inception:

a) Have cash flows that the entity expects will respond in similar ways to key drivers of risk in terms of amount and timing

b) Have similar expected profitability (i.e., similar CSM as a percentage of the premium).

The Board concluded that the grouping of contracts should be determined at inception and not be reassessed subsequently. All fourteen Board members agreed with this recommendation.

The Board also confirmed the decision on the level of aggregation does not change its previous conclusions reached on the topic of mutualisation. Where mutualisation[1] exists, the CSM may be determined taking into account cross subsidisation between contracts with different levels of expected profitability.

Allocation of the CSM

At a previous meeting, the Board tentatively decided that an entity should allocate the CSM to profit or loss over the coverage period in a way that best reflects the service provided under the contract.

The staff recommendation included in the staff paper for this meeting proposed that:

a) The objective is to recognise the CSM for an individual contract, or group of homogenous contracts, in profit and loss over the coverage period in a way that best reflects the service to be provided by the contract. If there is no more service to be provided by a contract, the CSM should have been fully recognised in profit or loss.

b) An entity can group contracts for allocating the CSM provided that the allocation of the CSM for the group meets the objective in (a).

c) An entity that groups contracts is deemed to meet the objective in (a) provided that:

   i. The contracts in the group meet the criterial for grouping contracts for onerous contracts mentioned above

   ii. The entity adjusts the allocation of the CSM for the group in the period to reflect the expected duration and size of the contracts remaining after the end of the period

The staff explained that part (c) of the proposal serves as a 'safe harbour' in which grouping of contracts for allocation of the CSM is deemed to meet the objective - if the prescribed conditions in (i) and (ii) are met.

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[1] 'Mutualisation' is intended to represent a contractual feature that results in policyholders sharing the risk relating to returns from underlying items - including the cost of any guarantees written to other policyholders

The Board agreed with the staff proposal that it should be possible to allocate the CSM at either the individual contract level or for a group of contracts - 12 Board members voted in favour of the staff proposal and two voted against. However, the Board asked the staff to clarify as part of drafting what the Board's intent is and how the above conditions could be applied.

Effect of regulation

The Board tentatively decided not to make an exception to the level of aggregation for determining onerous contracts or allocation of the CSM when regulation affects pricing. This means that contracts with dissimilar profitability cannot be grouped together for CSM amortisation or for determining whether an onerous contract loss should be recognised – even if the dissimilar profitability is a consequence of regulatory effects on pricing.

Regulation may affect the pricing of insurance contracts, for example by prohibiting the charging of different premiums to policyholders because of different characteristics such as gender, age or location of residence, even where there are significant differences in probability of an insured event occurring based on the characteristic. This is quite common in some jurisdictions, in particular when a product is mandatorily required to be underwritten (e.g. health, flood, or third party motor insurance).

The staff view was that a difference in profitability even if caused by regulation is a real economic difference between contracts, which provides information that should not be lost.

The majority of Board members agreed not to make an exception, expressing concern about the undesirable precedent that special treatment of insurance contracts would set for other industries that are also subject to rate regulation. One Board member also questioned, if such an exception were granted, whether regulation could be adequately defined and scoped. The Board also considered that an exception would increase complexity.

Four Board members did not agree with the staff view. They regarded losses imposed by regulatory pricing conditions on a particular group of policyholders as artificial and not reflecting real economics, with insurers forced to ignore relevant risk factors when pricing business. They discussed the example of car insurance where males and females are given insurance at the same price. In cases where a loss in regulated pricing for male drivers is compensated for by a higher CSM on the female part of the portfolio, in their view it would not be economic reality to recognise the loss for male drivers immediately.

How we see it

The tentative decision to clarify the level of aggregation for determining onerous contracts and allocating the CSM is an important step towards finalising the Insurance Contracts standard. By explicitly referring to a group of contracts, the Board has addressed uncertainty and concerns about its previous tentative decisions on the level of aggregation. Insurers will now need to evaluate the impact of this decision on how to implement the proposals in the new standard.

The safe harbour for allocation of the CSM is useful, but insurers will need to see the final text of the standard to determine what criteria should be applied to determining the aggregation level for CSM allocation beyond the safe harbour.

Determining discretion under the general model for participating contracts

Participating contracts often include cash flows that the entity expects to pay, but which it has the discretion to change. Such cash flows are included in fulfilment cash flows. Changes in estimates of discretionary future cash flows adjust the CSM because they relate to future service. At a previous meeting, the Board concluded that, when measuring the insurance liability under the general model (i.e., for indirect participating contracts), an entity should determine separately:

a) The effect of changes in market variables on the expected present value of future cash flows, which should be reported in the Statement of Comprehensive Income.

b) The effect of changes in discretion applied by the entity, which should adjust the remaining CSM.

IASB staff papers identify three steps in determining the effect of discretion on fulfilment cash flows to be applied in the following order:

- Define the nature of the approach or 'promise' an entity expects to apply when deciding on the amount to pay to policyholders of participating contracts (e.g., an intention to pay or credit policyholders with 90% of returns from general funds);
- Measure the expected cash flows assuming there is no change in the discretionary cash flows in a period (as if the entity has applied its intention or 'promise') at the current interest rate – and recognise the resulting change in measurement of the contract in the period in the statement of comprehensive income; then
- Measure the effect of any change in the discretionary cash flows (if discretion has been changed in the period), split into:
  - The effect measured at the rate at inception of the contract (recognised in CSM); and
  - The remaining change in discretionary cash flows measured at current rate being recognised in the Statement of Comprehensive Income.

How to identify changes in discretionary cash flows was previously discussed in the November Board meeting, when the staff outlined four possible approaches. At that meeting, the Board asked the staff to further consider two of the proposals. The proposals defined discretion either through using a market return on assets, or the actual return on assets held by an entity.

The staff concluded that basing discretion on the return of an entity's own assets may not always apply or be relevant to all contracts. Therefore, the staff recommended that the Board selected

- A view based on current market conditions, or
- An approach requiring an entity to specify at inception how it views its discretion and to use that specification in the distinction made between the effect of changes in market variables and changes in discretion.

The Board unanimously decided to adopt the latter approach. The staff clarified that under this approach:

- The specification would not necessarily be limited to current market returns or interest income on assets held, but could include whatever factors the entity uses to determine the amounts due to policyholders, such as reference assets not held by the entity or indices.
- If the entity is unable to specify in advance how it will determine the amounts due to policyholders, then the default benchmark would be a current market return.

The Board noted that the selected approach has the benefit of reflecting the way that an entity views its contracts and the resulting discretionary amounts paid to policyholders. However, it also acknowledged that selecting this approach was the result of a finely balanced choice between approaches that provide useful but different information. One Board member emphasised the importance of enforcing discipline by ensuring that an entity specify the effects of discretion at inception, thereby mitigating the risk of an entity achieving particular accounting results.

How we see it

The Board's tentative decision that an entity can specify its own view on distinguishing the impact of discretion from the impact of market movements for participating contracts accounted for under the general model should contribute to reducing the accounting differences to similar contracts accounted for under the variable fee approach. This is a result of having the ability to have a closer link between amounts adjusted against the CSM and the return earned on underlying items.

What's next?

With tentative decisions reached on the key issues of level of aggregation and discretion, the staff plans to ask the Board in the February Board meeting to review the due process steps taken in developing the model. The staff also intends to request permission to begin the drafting process for the new standard. The IASB expects to issue the new insurance contracts standard late 2016.

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