Discussion on the response to IASB

Q1 Contractual Service Margin

Do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if differences between the current and previous estimates of the present value of future cash flows if:

(a) differences between the current and previous estimates of the present value of future cash flows related to future coverage and other future services are added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative; and

(b) differences between the current and previous estimates of the present value of future cash flows that do not relate to future coverage and other future services are recognised immediately in profit or loss?

Why or why not? If not, what would you recommend and why?

Building block 3: Margins – Contractual Service Margin (recap)

A margin to eliminate any gain at inception of the contract

- CSM_0 can be thought of as the present value of future profits. CSM_t can be thought of as the present value of future profits at time t.
- Initially estimated and amortized at the level of portfolio of insurance contracts, with same inception date. ("cohort" concept)
    - "Portfolio" means polices with similar risk characteristics and managed together
- Calculated at initial recognition and amortized in subsequent valuations.
- Cannot be negative, as a loss must be recognized immediately through income

Contractual Service Margin

Main Issues to Consider

B 28 - B 30

- If non economic assumptions are weakened → Estimates of future profits increased → CSM also increased → P&L recognition deferred
- On the other hand if experience is deteriorates i.e assumptions are strengthened → Estimates of profits decreases → Change in excess CSM's absorbency is recognized immediately in P&L (CSM having a floor of zero)
- There will be asymmetry
- This appears inconsistent. However the rationae of doing so is presumably on grounds of prudence

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- Level of Aggregation on Portfolio level i.e Cohort level →e.g reporting on half year basis on 2 cohorts per year for each portfolio
- CSM is interpreted as estimates of future profits based & updated on non economic assumptions but locked in economic assumptions.

Whether this has an economic relevance?

Any further comments??

Q2 Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

If a contract requires an entity to hold underlying items and specifies a link between the payments to the policyholder and the returns on those underlying items, do you agree that financial statements would provide relevant information that faithfully represents the entity's financial position and performance if the entity:

(a) measures the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items?

(b) measures the fulfilment cash flows that are not expected to vary directly with returns on underlying items, for example, fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated, in accordance with the other requirements of the [draft] Standard (i.e. using the expected value of the full range of possible outcomes to measure insurance contracts and taking into account risk and the time value of money)?

Q2 Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items

(c) recognises changes in the fulfilment cash flows as follows:

(i) changes in the fulfilment cash flows that are expected to vary directly with returns on the underlying items would be recognised in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of those underlying items;

(ii) changes in the fulfilment cash flows that are expected to vary indirectly with the returns on the underlying items would be recognised in profit or loss; and

(iii) changes in the fulfilment cash flows that are not expected to vary with the returns on the underlying items, including those that are expected to vary with other factors (for example, with mortality rates) and those that are fixed (for example, fixed death benefits), would be recognised in profit or loss and in other comprehensive income in accordance with the general requirements of the [draft] Standard?

Why or why not? If not, what would you recommend and why?

“Participating” Contracts

- Some insurance contracts (e.g with profits)generate cash flows that vary with the returns on the underlying items.
- IASB has proposed a “mirroring approach” for variable cash flows that depend on the development of underlying items in contacts that require the entity to hold underlying items and specify a link to returns on those underlying items.
- Therefore, a dispensation has been granted to avoid accounting mismatches where economic mismatch does not exist.
- *Paragraph B84b “the entity could choose to hold the underlying items and so could avoid economic mismatches, but is not required to hold the underlying items”*
  - *Because of significant discretion available to bonus setting, there is a clarification required*
- Also treatment of inherited estate and cash flow to and from estate is not very clear

Decomposition of Cash flow

Main Issues to Consider

Variable Cash Flow	Measure by reference to carrying value of the underlying item
Indirectly Variable Cash Flow	Measurement according to the BBA (options and guarantees)
Fixed Cash Flow	Measurement according to the BBA (changes related to future services against CSM)

- Method of decomposition of cash flows is quite complex.
- For indirectly varying cash flows the changes in expected value of cash flows are recognized in P&L
- But for contracts where the entity is not required to hold the underlying assets and / or where the cash flow do not vary with underlying items, the accounting for these changes seems to imply use of OCI for changes in discount rates and unlocking of CSM
- In general, the different ways in which an entity might identify which of the cash flows that are expected to vary directly with returns on underlying items would result in different amounts being recognised in profit or loss and OCI.’

Decomposition of Cash flows

Main Issues to Consider

- Further changes in the value of some options embedded in insurance contracts wholly in profit or loss if the contract requires the entity to hold underlying items and specifies a link to those underlying items. Thus, there would be an inconsistent presentation of changes in the value of options and guarantees embedded in insurance contracts, depending on whether the options and guarantees are embedded in a contract that requires the entity to hold underlying items and specifies a link to returns on those underlying items.

- Alternate method to split the expected return from the unexpected return is how the information is currently reported by European companies under EEV and MCEV Principles,

  The effect of investment income is segregated between the expected income and the rest, which is reported as an investment variance. However, the expected income is not specified by reference to the discount rate applicable at initial recognition, but by reference to that at the valuation date. Such an approach would appear more relevant and provide more a more transparent representation of the entity's performance

- Distinction between a fixed cash flow and one that varies with underlying items may not be clear in business with discretionary participation features, since the extent to which future bonus or dividend rates may be varied would be a matter a judgement

Q5 Effective date and transition

- Do you agree that the proposed approach to transition appropriately balances comparability with verifiability?

Why or why not? If not, what do you suggest and why?

Transition - recap

At the beginning of the earliest period presented, an entity shall …

Measure each portfolio of insurance contracts as sum of:

(i) the fulfillment cash flows; and

(ii) a contractual service margin

The cumulative effect of difference between expected present values of cash flows at beginning of earliest period presented, discounted using:

(i) current discount rates at earliest period; and

(ii) the discount rates applied when portfolios were initially recognised

Effective date and transition

Main Issues to Consider

- Discount rates that applied at the point of initial recognition of the in-force business may have very little economic relevance at the date of transition.
- Purpose of this retrospective calculation appears to be to enable a current estimate of the two liability building blocks on the discount rates which would have applied on initial recognition of the liabilities. Then, they may continue to accrete interest at these rates in the P&L account in future, with the residual amount of interest to be recognised in the OCI. Whether this would eliminate accounting mismatches would depend on the treatment of the existing assets, but since accounting mismatches are unlikely to be eliminated prospectively under this (draft) Standard, they are equally unlikely to be eliminated by either a fully retrospective application
- The proposed approach would lead to a disjuncture in the emergence of surplus and hence the recognition of profit on the business in force at the date of transition
- May lead to a disjuncture in the year-on-year tax liability in jurisdictions where financial statements are the basis of the tax computation