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IFRS: Insurance and Investment Contracts

IAS39 Taskforce

Adoption of IFRS

- Australia will adopt IFRS for reporting periods beginning on or after 1 January 2005.
- AASB Standards are being changed to adopt IASB Standards effective 1 January 2005 by replacing existing AASB Standards with Australian standards equivalent to those of the IASB.
- A revised version of AASB1038 has been produced.
- A range of other accounting standards are also relevant for financial services companies.
- This session has a focus on AASB1038, *AASB139 Financial Instruments: Recognition and Measurement* and *AASB118 Revenue* as these standards are key in financial reporting for financial services contracts.

Which Standards Apply to Which Contracts?

- *An insurance contract is defined as a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specific uncertain future event (the insured event) adversely affects the policyholder.*
- An “insurance” contract will be accounted for under a new version of AASB 1038 (Life Insurance) or AASB1023 (General Insurance.)
- A contract governed by the LIA 1995 that is not an insurance contract is an investment contract, and will be accounted for as a financial instrument.
- Contracts with discretionary participation features will be treated as if they are life insurance contracts for Phase 1 of IFRS – the “significant insurance risk” test does not apply.
- Classification for most contracts is straightforward but there may be some “grey areas” which require deliberation.

Unbundling

- Unbundling is allowed where the deposit component of a contract can be reliably measured on its own.
- The unbundling approaches already applied by Australian life insurers are expected to continue to be appropriate.
- This means that for investment contracts with risk riders, the investment component of a contract can be accounted for as a financial instrument, whilst the risk riders can be accounted for as insurance contracts.
- Unbundling is distinct from premiums/claims splitting which continues to be required under the revised AASB1038.

Classification for Typical Financial Services Contracts

- Insurance Contracts (Life) would typically include:
  - Retail and group contracts covering death, trauma, TPD and disability income
  - Lifetime annuities
  - Risk riders to investment contracts
  - Non-participating whole of life/endowment
  - Reinsurance with significant risk attached
- Investment Contracts would typically include:
  - Retail and wholesale unit linked contracts and non-participating investment account contracts (excl. risk riders)
  - Term certain annuities
  - Financial reinsurance
- Contracts which would be treated as Insurance Contracts due to participating features would include:
  - Participating whole of life/endowment
  - Participating retail and wholesale investment account

Accounting for Investment Contracts - Basis

- A discussion draft of a guidance note has recently been issued by the IAS39 Taskforce (DDGN550.)
- It is proposed that investment contracts will be accounted for in two parts – the financial instrument under AASB139 and the management services element under AASB118. A surrender value floor applies to the financial instrument component.
- In simple terms, this would usually result in a liability equal to account value or surrender value, and a DAC asset. This is similar to an accumulation approach under current standards but with the DAC shifting from being a negative liability to an asset.
- A narrower test applies in determining whether or not initial expenses are deferrable. It is clear that less expenses will be deferred than under current standards but the extent of deferral continues to be debated.
- For term certain annuities, it is likely that a projection approach will continue to be required.
- Embedded derivatives must be identified and fair valued.

Deferrable Acquisition Costs - Quantum

- New standards will allow the deferral of “incremental” acquisition costs only.
- There continues to be debate as to which costs are incremental and which costs are not.
- The key issue to resolve is the level at which “incremental” is tested; contract or portfolio level? If portfolio, over what time scale?
- It is clear that there will be less deferral of acquisition expenses in future than applies under the current version of AASB1038.
- There is discussion on this issue in an appendix to the DDGN 550 explanatory guidance. The appendix introduces a framework of splitting expenses into six tiers, then considers each in turn.
- Where a service company is in place, a look through approach should apply.

Acquisition Costs – Tiers and Examples

- Tier 1: directly variable with the acquisition of every contract
  - initial commission (with no offsetting initial fee)
- Tier 2: highly variable with volume of new business
  - volume bonus, salaried sales force, direct marketing costs
- Tier 3: somewhat variable and linked to Tier 2 expenses
  - support to distribution channels, new business admin, PDSs
- Tier 4: costs that are unlikely to vary with volume of new business
  - marketing salaries, systems development
- Tier 5: overhead costs
  - corporate costs, IT infrastructure costs
- Tier 6: costs not considered acquisition (and not deferred now)
  - general advertising, brand maintenance

Where should the cut off be ?

Deferrable Acquisition Costs – Run-off

- Currently, DAC run-off follows a projection approach or, provided the principles of AS1.03 have been applied, an accumulation approach. There can be profit volatility from the impact of experience elements on the DAC.
- IFRS does not require a projection approach. An explicit DAC is likely and it may be possible to use "simpler" methods to calculate DAC than are currently used.
- DDGN550 notes that a DAC methodology consistent with AASB118 should not excessively capitalise changes in expected future revenue into the current period.
- A DAC recoverability test will apply. Where this test is not met, a provision will be applied against the DAC asset.

Deferrable Acquisition Costs – Run-off Methodology

- Examples of issues to consider in deciding “DAC methodology” include:
  - will a projection approach continue to be used?
  - if there is an explicit deferral period, what should it be?
  - if there is a DAC carrier, what should it be?
  - will DAC balances be impacted by investment experience?
  - will DAC balances be impacted by surrender experience?
  - will DAC balance be discounted or undiscounted? (earn interest?)
  - will DAC balances be calculated gross or net of tax?

Discount Rates

- Under current standards, the liability discount rate is derived from the assets backing the liability. There is also a requirement to allow for credit risk.
- Under new standards, for both investment and insurance contracts, the liability discount rate is to be derived independently of the assets backing the liability, unless benefits are linked to asset performance.
- AASB1038 refers to "*risk-free discount rates based on current observable, objective rates that relate to the nature, structure and term of the future obligations*" and notes that "*government bond rates may be appropriate discount rates … or they may be an appropriate starting point in determining such discount rates*."
- For investment contracts, the discount rate will be derived from the replicating portfolio, as discussed in DDGN 550.

Discount Rates - Annuity

- Different standards will therefore apply to term certain and lifetime annuities although practical outcomes *may* be similar.
- A replicating portfolio to exactly match term annuity cashflows would match timing, amount, credit standing and liquidity.
- For term annuity contracts written by Australian insurers, own credit risk relating to the annuity payments is very low and there would generally not be an increase in discount rate due to own credit standing.
- For companies backing lifetime annuities with assets other than government debt, discounting at a risk free rate could result in new business strain on new annuity contracts, with higher ongoing profit emergence as liquidity/credit margins emerge as earned.
- One potential interpretation for annuities backed by corporate debt could be to use the government bond rate of an appropriate term as a starting point, and add a liquidity margin to this. The liquidity margin could be derived as the margin between corporate debt and government debt, less an allowance for credit risk. To the extent that the allowance for credit risk mirrors the allowance currently required under AS1.03, there may not be a discount rate-related change in liability from current practice.

Implementation Issues

- On adopting IFRS reporting, companies are required to create opening positions “as if” the new standards had applied in the past.
- Changes to opening liabilities are to be put through retained earnings; there is no reported profit impact in the reporting year when new standards start applying.
- The financial instrument component of the liability will be straightforward to create but the investment contract DAC position at IFRS adoption date could be complex to create. Pragmatic approaches may be developed, for example applying the current year ratio “IFRS deferrable” : “MoS deferrable” expenses to the “MoS DAC,” to derive the IFRS DAC, with alternative approaches required for closed products. If only Tier 1 were deferred then a more robust approach may be quite simple.
- These issues are likely to apply to similar contracts written by funds management companies; the accounting framework does not differ based on whether or not the issuer is a life insurance company.

Discussion Topics

- Classification challenges
- Extent of acquisition deferral – where should the “Tier” cut off be?
- DAC run-off methodology – have companies decided on future approach? How is this likely to differ from current “Margin on Services” approach?
- Annuity discount rates
- Opening DAC balances
- Involvement in funds management companies