EFRAG IAWG Questionnaire results
Issues Paper

Objective

1 The objective of this paper is to provide detailed input received to the EFRAG IAWG Questionnaire on the questions asked by EFRAG TEG members in October 2017 relating to particular topics.

Clarifications asked by EFRAG TEG members

2 At its October 2017 meeting, EFRAG TEG was provided with an executive summary of the responses received from the EFRAG IAWG questionnaire. EFRAG TEG requested EFRAG IAWG to provide more information relating to:

(a) the unit of account used;

(b) identification of onerous contracts; and

(c) how the current accounting practices support the long-term liability-driven business model.

Unit of account used

3 In the 14 November 2017 meeting, EFRAG IAWG members noted that different units of account are used for different purposes, hence it is important to understand what is being assessed and measured.

Detailed input received to the Questionnaire

4 Respondents rely on different units of account for different purposes. The following is a summary by product category.

Life and health contracts

5 Eleven respondents stated that the individual contract level is used for measuring life and health insurance liabilities or provision of technical reserves.

6 Other units of account used for different purposes were:

(a) <u>Portfolio or group level</u>:

(i) Measurement and impairment testing of deferred acquisition costs (DAC) and acquired value in force (AVIF) (three respondents);

(ii) Measurement of profitability (two respondents);

(b) <u>Line of business or group level</u>:

(i) Specific technical provisions to cover targeted deficiencies either for life (such as the provision for administration expenses deficiency, the provision for financial yield deficiency) or non-life (unexpired risks reserve) (two respondents);

(c) By risk or certain groups of contracts for life participation reserves, specific guarantees, specific technical provisions to cover targeted deficiencies, provision for interest rate risk, for IBNR reserves (four respondents);

(d) Ring-fenced fund level or at the entity level: for life participation reserves for both payable and deferred policyholders' profit sharing (one respondent);

(e) Consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability: to determine if a premium deficiency exists (one respondent);

Non-life contracts

7 Seven respondents stated that the individual contract level is used for measuring non-life insurance liabilities.

8 Other units of account used for different purposes were:

(a) Portfolio or group level:

(i) IBNR claims calculation (three respondents);

(ii) Unexpired risk provisions (one respondent);

(iii) Unspecified: (two respondents);

(b) Statistical method: two respondents;

(c) Actuarial business segments: provision for outstanding claims (one respondent);

(d) Homogeneous category of contracts: for unearned premiums reserves calculation or unexpired risks reserves calculation (two respondents);

(e) Product type: provisions for premiums (one respondent).

Investment contracts

9 Seven respondents stated that the individual contract level is used for measuring investment contract liabilities.

10 Other units of account used for different purposes were:

(a) By risk or group of contracts: for life participation reserves, specific guarantees, specific technical provisions to cover targeted deficiencies (one respondent);

(b) Consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability: to determine if a premium deficiency exists (one respondent).

With-profits contracts

11 Respondents noted to use the following units of account:

(a) Individual contract: for asset share information (two respondents);

(b) Product level: for the cost of guarantees by type of guarantee (one respondent);

(c) Total fund level: for unallocated distributable surplus (one respondent);

(d) Portfolio or group level:

(i) For stochastically modelled liabilities (one respondent);

(ii) For associating DAC to premium revenue (one respondent);

(e) Entire line of business: for the premium deficiency test or loss recognition test (one respondent).

Unit-linked contracts

12 Nine respondents stated that the individual contract level is used for measuring unit-linked insurance liabilities.

13 Other units of account used for different purposes were:

(a) Portfolio or group level:

(i) DAC and AVIF (one respondent);

(ii) For acquisition costs, acquiring, servicing, and measuring the profitability.

(iii) For the IBNR calculation (one respondent);

(b) By risk or certain groups of contracts: for life participation reserves, specific guarantees, specific technical provisions to cover targeted deficiencies;

(c) Consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability: to determine if a premium deficiency exists (one respondent);

(d) Product level or industry statistics: for estimates used in individual contract level.

Reinsurance ceded

14 Four respondents stated that the individual contract level is used for measuring reinsurance ceded insurance liabilities.

15 Four respondents indicated that the measurement depended on the underlying contract and on the contractual terms of the reinsurance contract.

16 Other units of account used for different purposes were:

(a) Portfolio or group level:

(i) For the IBNR calculation (one respondent);

(ii) For acquisition costs, acquiring, servicing, and measuring the profitability (one respondent).

Reinsurance assumed

17 Four respondents indicated that the measurement depended on the underlying contract and on the contractual terms of the reinsurance contract.

18 Two respondents stated that the individual contract level is used for measuring reinsurance assumed insurance liabilities.

19 One respondent commented that for unearned premiums of reinsurance, nominal percentages are used in some cases where the data for a calculation pro rata temporis is not available (one respondent).

Identification of onerous contracts

Detailed input received to the Questionnaire

20 Three respondents stated that there is no requirement to identify onerous contracts under the current GAAP. Three other respondents refer to the liability adequacy test under IFRS 4. Of these one also referred to the unexpired risk reserve as an additional provision to supplement the provision for unearned premiums for those contracts where the estimated total amount of claims and administrative costs under the contract exceed the total unearned premiums and premiums receivable. One respondent pointed out that certain contracts such as health contracts or non-life contracts have a fixed renewable right for the entity to adjust premiums after each

term. Therefore, onerous contracts and related losses are automatically considered in these cases.

21 One respondent referred to the liability adequacy test under IFRS 4 and explained that they use the recoverability test at inception and loss recognition test under US GAAP for these purposes. Another confirmed that the determination for long term contracts are concluded on a particular line of business level and that in cases where there may be profits in early years and losses in later years, the liability will be increased to compensate for those losses. Premium deficiency and loss recognition is performed by product portfolio.

22 Another respondent confirmed that onerous contracts are not identified, and clarified that this is not required as the liabilities reflect discounted future cash flows with no deferral of profit or acquisition costs. However, where US GAAP is applied for US fixed, fixed index and variable annuities, onerous contracts are considered if they restrict the recoverability of DAC. The testing is done at a group level of contracts managed together.

23 A further respondent agreed, but added that DAC and related intangibles such as acquired in-force by category of business, are tested for impairment at each reporting date and written off where no longer recoverable. Furthermore, for non-life contracts, claims incurred provisions include allowances for risk and uncertainty as well as unexpired risks. For with-profits contracts, any excess of the aggregate carrying value of liabilities over that of the assets is held as a negative unallocated distributable surplus subject to recoverability of margins. Any excess over the recoverable amount is charged to the profit and loss in the reporting period. For unit-linked contracts, non-unit reserves are calculated on a prudent basis and no negative non-unit reserves recognised. DAC and related intangibles by category of business are tested for impairment at each period and written off when considered to not be recoverable.

24 Two respondents explained that for life and health contracts, there are two provisions that deal with onerous contracts. At the level of respondents of homogenous contracts, an overall reserve for future policy management expenses not covered by premiums is made. Secondly, a reserve for financial yield deficiency that compensates for a yield reduction of financial assets. At a business line level, for non-life contracts an unexpired risk reserve is created for expected cash outflows not covered by the unearned premium reserve. For unit-linked contracts with guaranteed minimum death benefits an additional reserve may be required when the market value of underlying assets does not cover the guaranteed amount. Another respondent said that the respondent identifies onerous contracts through local accounting rules, MCEV calculations and the accuracy of existing claims reserving.

25 A respondent commented where future costs will exceed expected premiums, an additional provision will need to be recognised and the related DAC impaired. Another respondent commented for unit-linked and investment contracts the full risk is with the policyholder. For non-life contracts a minimum adequacy test is required and a provision is required when the expected cost of claims is higher than the premium reserve plus premiums of the following year(s). A provision for impending losses is calculated on a business-line basis by estimating future cash flows for premiums earned, claims, administrative costs and withdrawals from the equalisation reserve.

Long-term liability-driven business model

Detailed input received to the Questionnaire

26 Four respondents provided reasons why they believe the GAAP they are using support the presentation of performance in exercising a long-term liability-driven business model. Examples of explanations are elaborated below.

27 Five respondents indicated that their current GAAP does not (fully) support the presentation of their performance under a long-term liability-driven business model. Examples of explanations are enumerated below.

28 One respondent had mixed views and stated that there is, in their opinion, no specific provision illustrating the long-term liability-driven business model. Some combine some provisions of IFRS 4 and IAS 39 (shadow accounting and available for sale accounting) which allows them to separate some short-term volatility from underlying and realised performance, although imperfectly as still non-GAAP measures need to be used.

29 Three respondents stated that the question was not applicable to them. One respondent did not answer the question.

Explanations why current GAAP supports the long-term liability-driven business model

30 The following explanations were provided by the entities responding to the questionnaire:

(a) National GAAP requires that economic and non-economic assumptions used to value contract liabilities are updated at each reporting date meaning that liability valuations are based on best estimate current assumptions (with margins for prudence then added to these) and valuation interest rates used to discount contract cash flows are based on the current asset yield with deductions for the credit risk element of the yield;

(b) Valuation interest rates used to discount contract cash flows are based on the current asset yield with deductions for the credit risk element of the yield. This enables a degree of matching in the income statement between fair value movements in respect of the assets backing insurance liabilities and the movements in the value of the liabilities driven by changing economic assumptions;

(c) Changes in measurement impact equity rather than profit or loss;

(d) Mathematical reserves take into account the long-term effect of the contract. The use of FVOCI limits volatility in P&L and therefore supports the presentation of performance in exercising a long-term liability-driven business model. Similarly, the use of shadow accounting mitigates the impact of the measurement mismatch and therefore supports the presentation of performance in exercising a long-term liability-driven business model.

(e) The long-term liability-driven business model is supported by the extensive use of OCI with recycling for financial assets and shadow accounting for insurance liabilities. This permits:

(i) Avoiding short-term fluctuations in the P&L;

(ii) Recognising capital gains in the P&L when realised;

(iii) Attributing to the shareholders and policyholders the unrealised gains and losses coming from the differences between fair values and statutory value of underlying items.

Explanations why current GAAP does not support the long-term liability-driven business model

31 The following explanations were provided by the entities responding to the questionnaire:

(a) Single premiums are recognised in the financial year when received;

(b) National GAAP does not fully reflect the long-term business model and therefore IFRS operating profit is used as management's primary measure of profitability. This provides an underlying operating result based on long-term investment returns and excludes short-term fluctuations in investment returns and non-operating items.

(c) Accounting for long-duration contracts has shortcomings under current GAAP. For example, most options and guarantees are not reflected in the measurement of the insurance liabilities at their fair value. Therefore, insurers use for the life business non-GAAP measures such as MCEV to explain the performance of the business.

(d) The reporting principles currently applied are strictly reporting-date orientated and do not include any forward-looking cash flow projections. Input parameters are determined under very conservative assumptions, because prudence is one of the main principles under national GAAP.

(e) Other locally developed financial indicators allow to analyse and follow-up the performance of a long-term business model. For example, a standard for calculating and presenting the total return on policyholder assets and a note to explain the difference between that calculation and the IFRS financial statements.

(f) The balance sheet according to GAAP, in combination with Solvency II capital requirements, partially present a better view of the long-term business model, by measuring the insurance liability according to some sort of current value and measuring all assets at fair value.

Questions for EFRAG TEG

32 Does EFRAG TEG have any other questions on current practice in relation to the above topics?