SLFRS 4 –Insurance Contracts.

August 2012

Objective & Scope

SLFRS 4 –Insurance Contracts
July 2012.

Objective

The objective of this SLFRS is to specify the financial reporting for *insurance contracts* by any entity that issues such contracts (described in this SLFRS as an *insurer*) until the second phase of its project on insurance contracts is completed.

SLFRS 4 requires:

- limited improvements to accounting by insurers for insurance contracts.
- disclosure that identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.

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Scope

An entity shall apply this SLFRS to:

1 **Insurance contracts** (including *reinsurance contracts*) that it issues and reinsurance contracts that it holds.

***Insurance Contract**:*
*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 **specified uncertain future event (the insured event)** **adversely affects** the policyholder.*

***Insurer** as per SLFRS 4 is any entity that issues insurance contract, irrespective of whether the entity is considered an insurer for legal/ regulatory purposes.*

All reference in this SLFRS to insurance contracts also apply to reinsurance contracts.

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Scope (contd.)

An entity shall apply this SLFRS to:

2 <u>**Financial instruments**</u> **that it issues** <u>**with a *discretionary participation feature***</u> **.**(SLFRS 7 *Financial Instruments: Disclosures* requires disclosure about financial instruments, including financial instruments that contain such features.)

<u>**Discretionary Participation Feature**</u>

A contractual right to receive, ***as a supplement to guaranteed benefits***, **additional benefits:**

(a) that are likely to be a significant portion of the total contractual benefits;

(b) whose amount or timing is contractually at the discretion of the issuer; and

(c) that are contractually based on:

(i) the performance of a specified pool of contracts or a specified type of contract;

(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

(iii) the profit or loss of the company, fund or other entity that issues the contract.

Guaranteed benefits- Payments or other benefits to which a particular Policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.

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Scope (contd.)

An entity shall apply this SLFRS to:

3. <u>Embedded Derivatives</u>

- LKAS 39 require an entity to separate some embedded derivatives from their host contract, measure at fair value and include the changes in FV in the P&L.
- **An insurer need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract.**
- LKAS 39 will apply to all other instances- embedded derivative and are not closely related to the host contract need to be measured at fair value.

Embedded Derivative

A component of a hybrid instrument that includes both a derivative and a host contract – with the effect that some of the cash flows of the combined instrument vary in a similar way to a stand-alone derivative.

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Examples- embedded derivatives requiring fair-value treatment

Type	Fair value required
Death benefit equal to max (sum assured: unit value)	No
Guaranteed annuity option	No
Minimum interest guarantee on surrender or maturity (option at or out of money at inception, and not leveraged)	No
Minimum annuity payments linked to investment returns or asset prices. (a) Payments are life contingent (b) Payments are not life-contingent	 No Yes
Minimum equity or equity linked returns on surrender or maturity	Yes

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Scope (contd.)

An entity shall apply this SLFRS to:

4. Unbundling of deposit component.

- Requires an insurer to unbundle (i.e. account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its statement of financial position.
  - Required if both of the following conditions are met;
    - I. the insurer can measure the deposit component (including any embedded surrender options) separately (ie without considering the insurance component).
    - II. the insurer's accounting policies do not otherwise require it to recognize all obligations and rights arising from the deposit component.
- unbundling is permitted, but not required, if the insurer can measure the deposit component separately as in (a)(i) but its accounting policies require it to recognise all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations.
- unbundling is prohibited if an insurer cannot measure the deposit component separately as in (a)(i).

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SLFRS 4- Scope Exclusions

Excluded from Scope	Applicable Standards
Product warranties issued directly by a manufacturer, dealer or retailer	LKAS 18 *Revenue* and LKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
employers' assets and liabilities under employee benefit plans	LKAS 19 *Employee Benefits* /SLFRS 2 *Share-based Payment* / LKAS 26 *Accounting and Reporting by Retirement Benefit Plans*
contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (e.g. some licence fees, royalties, contingent lease payments and similar items), as well as a lessee's residual value guarantee embedded in a finance lease	LKAS 17 *Leases*, LKAS 18 *Revenue* and LKAS 38 *Intangible Assets*
contingent consideration payable or receivable in a business combination	SLFRS 3 *Business Combinations*

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SLFRS 4- Scope Exclusions (contd.

Excluded from Scope	Applicable Standards
Financial guarantee contracts	LKAS 39
Financial guarantee contracts previously designated and accounted as insurance contracts.	Choice to elect to apply either LKAS 39, LKAS 32 and SLFRS 7 or SLFRS 4 to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.
Direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the *policyholder*). However, a *cedant* shall apply SLFRS 4 to reinsurance contracts that it holds.	e.g. – Policy on Gratuity – LKAS 19- Employee Benefits

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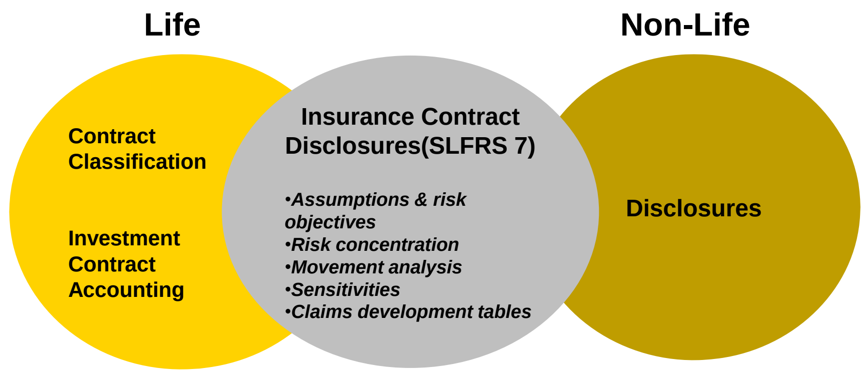
SLFRS 4-Phase 1- Recap

SLFRS 4 applies to insurance contracts and not to insurance entities. Any entity that issues an insurance contract is regarded as an insurer by SLFRS 4 whether or not the entity is regarded as an insurer for legal or supervisory purposes. Consequently, non-insurance companies will be caught within its scope if they issue contracts that meet the above definition of an insurance contract.

SLFRS 4 does not distinguish between life (or long-term) and non-life (or short-term) insurance contracts or between insurance and reinsurance contracts.



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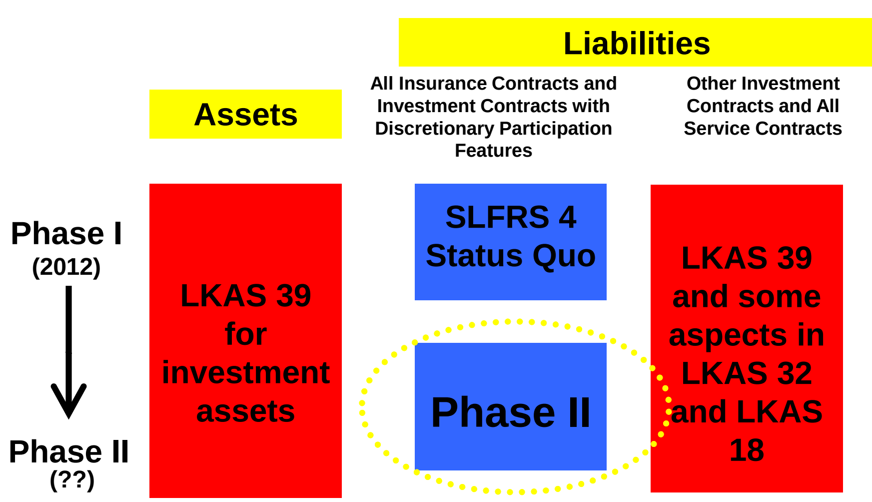
Overview of key SLFRS standards for Insurance Companies



Product Classifications.

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Overview of an Insurer's Balance Sheet

Assets		Liabilities	
Investments: Equities Fixed Interest Mortgages (?) Loans	LKAS 39	Equity	Various Co's Act No 7 of 2007 LKAS 32/39
Property	LKAS 16/ LKAS 40	Insurance Liabilities (including investment contracts with Discretionary participation features)	SLFRS 4
Investment Contract DAC	LKAS 18		
Insurance Contract DAC	SLFRS 4		
PVIF	SLFRS 4	Investment Contract Liabilities	LKAS 39
Other Assets	Various	Other Liabilities	Various

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Why is product classification Important?

- Product classification determines the accounting treatment for contracts during phase 1.
- Product Classification
  - A major exercise for insurance companies
  - A hot topic for the future as product complexity increases
  - Solutions developed to address complex classification issues

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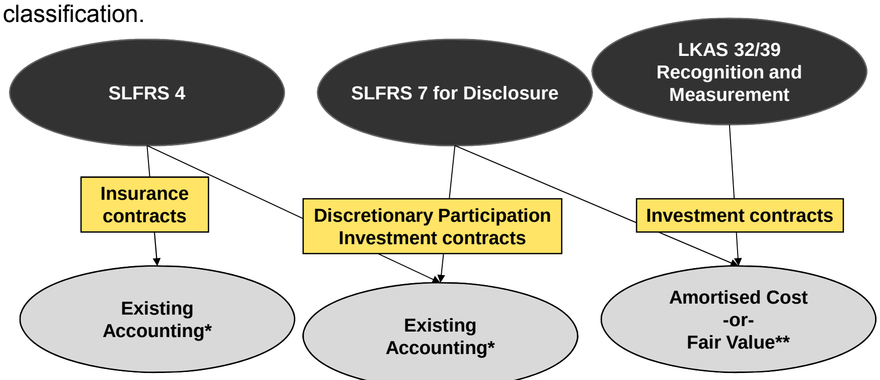
Insurance product classification
Why product classification?

Product classification is very important <u>as it defines the accounting treatment for the issued contracts by an insurer.</u> The following chart provides an overview of the accounting treatment for different types of contracts as a result of product classification.



*Subject to certain modifications

**Possibly with separate accounting for service component

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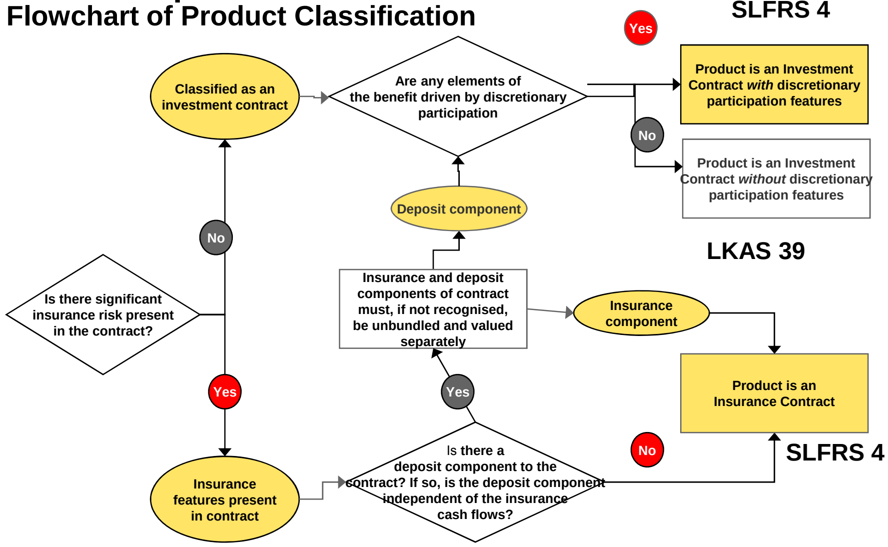
Insurance product classification
Flowchart of Product Classification



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Insurance product classification
Key steps to identify an insurance contract

Based on the <u>definition of an insurance contract</u>, an insurance contract must have <u>all of the following three</u> characteristics:

1. Uncertain future events (Insured event)
2. Transfers significant insurance risk from the policyholder to the insurer
3. Adverse effect on the policyholder

Insurer -The party that has an obligation under an **insurance contract** to compensate a **policyholder** if an **insured event** occurs.

Policyholder- A party that has a right to compensation under an **insurance contract** if an **insured event** occurs.

Insured event- An uncertain future event that is covered by an **insurance contract** and creates **insurance risk**.

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Insurance product classification
Key steps to identify an insurance contract
1. <u>Uncertain future events (Insured event)</u>

At least one of the following is uncertain at the inception of an Insurance Contract

- Whether an Insured event will occur
- When it will occur
- How much the insurer will need to pay if it occurs.

Insured event- An uncertain future event that is covered by an **insurance contract** and creates **insurance risk**.

Insurance risk - Risk, other than **financial risk**, transferred from the holder of a contract to the issuer.

Financial risk-The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

SLFRS 4 –Insurance Contracts
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Insurance product classification
Key steps to identify an insurance contract

1. <u>Uncertain future events (Insured event)</u>

The events should not include:

- Charges on cancellation or surrender
- Loss of ability to charge policyholder for future services (e.g., if a contract terminates on death)
- Possible reinsurance recoveries as these are classified separately
- Lapse or persistency risk (the risk that the counterparty will cancel the contract earlier or later than the issuer had expected in pricing the contract) is not insurance risk because the payment by the counterparty to the issuer is not contingent on an uncertain future event that adversely affects the counterparty.

SLFRS 4 –Insurance Contracts
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Insurance product classification
Key steps to identify an insurance contract

2. *Transfers Significant insurance risk*
Testing for significant insurance risk (to be assessed contract by contract)

Feature	Significant
Significant additional benefits payable on insured event by the insurer.	yes
Costly and feasible event in scenario of commercial substance even if it is extremely unlikely	yes
Waiver on death of surrender or cancellation charges	No
Loss of ability to charge for future services (e.g. in an investment- linked life insurance contract, the potential loss of future investment management fees due to death of policy holder during the contract cannot be considered)	No
A payment conditional on an event that does not cause a significant loss to the holder.	No
Possible reinsurance recoveries (Insurer accounts for these separately)	No

SLFRS 4 –Insurance Contracts
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Insurance product classification
Key steps to identify an insurance contract

3. Adverse effect on the policyholder

- For a contract to be an insurance contract there must be an adverse effect on the policyholder. In other words, there must be an insurable interest.
- A payment conditional on an event that does not cause a significant loss to the holder of the contract is not an insurance contract. An example of this is a contract that requires the issuer to pay Rs one million if an asset suffers physical damage causing an insignificant economic loss of Rs 100 to the holder. The holder has transferred to the insurer the insignificant risk of losing Rs 100. Therefore cannot be considered an insurance contract.
- Similarly, expense risk (the risk of unexpected increases in the administrative costs associated with the serving of a contract, rather than the costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the counterparty.

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Product Classification Examples
Life Products

Insurance	Investment	Corridor
Significant Insurance Risk	Insignificant Insurance Risk	Classification Unclear
Whole Life Contracts and prepaid funeral plans Term assurance and Pure endowment assurance	Life insurance contracts in which the insurer bears no significant mortality risk. (e.g. Investment contracts) Guaranteed investment contract or bond	Bank certificate of deposit with waiver of surrender penalty on death
Life contingent annuities, and pensions (compensation for uncertain future event of the survival of the pensioner or annuitant to maintain a given standard of living that would have got affected by survival)	Pension accumulation contracts without significant death benefits Annuities certain (i.e. that pay regardless of survival) Deferred annuity with no life contingency or insurance guarantee	Pensions with return of premiums on death Fixed term annuities sold to young ages

SLFRS 4 –Insurance Contracts
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Product Classification Examples-
Life Products -Contd.

Insurance	Investment	Corridor
Significant Insurance Risk	Insignificant Insurance Risk	Classification Unclear
Variance annuities with significant death benefit	Financial derivatives	Waiver of surrender charge on death
Fixed or variable (unitlinked) with significant life contingent annuity guarantee	Variable or unit-linked without significant death benefit.	Products with rider options.

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Product Classification Examples
Non- Life Products

Insurance	Investment	Corridor
Significant Insurance Risk	Insignificant Insurance Risk	Classification Unclear
Most Property / Casualty Insurance Contracts	Contract exposed to lapse or expense risk only	Property/ casualty with experience payments/rating mechanisms
Insurance against professional liability, civil liability or legal expenses.		
Third-party warranties	Warranties issued directly by manufacturer	Products with rider options.
Reinsurance catastrophe bond with triggers related to the issuer's losses	Guaranteed investment contract or bond	Reinsurance catastrophe bonds with triggers not directly related to the issuer's losses
Disability and medical cover		Experience –rated group business, with premium deficit recoverable.

IFRS 4 - Measurement for Insurance Contracts

SLFRS 4 –Insurance Contracts
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Measurement for Insurance Contracts
The hierarchy exemption and constraints

<u>The hierarchy exemption</u>

SLFRS 4 does not provide guidance on what accounting policies should be used by an entity that issues insurance contracts or investment contracts with DPF. Instead, the standard creates a temporary exemption from the hierarchy in LKAS 8 (the 'hierarchy exemption').

SLFRS 4 exempts an insurer from applying paragraphs 10-12 of LKAS 8 for:

- **a) insurance contracts that it issues (included related acquisition costs and related intangible assets); and**
- **b) reinsurance contracts that it holds**

Paragraphs 10-12 of LKAS 8 specifies the criteria an entity uses in developing an accounting policy if no SLFRS applies specifically to an item. The exemption for applying the criteria means that an insurer is permitted to continue its existing accounting policies while need not consider whether its existing accounting policies are consistent with the framework or other SLFRS's or whether they result in information that is 'relevant' or 'reliable' as defined by the framework.

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Measurement for Insurance Contracts
The hierarchy exemption and constraints

However, there are several constraints to the hierarchy exemption as follows:

Discontinue	Allowed to continue but not start	Required to continue or start
Catastrophe reserves	Undiscounted basis of valuation	Liability Adequacy Test
Equalization reserves	Deliberate overstatement of liabilities	Gross presentation of reinsurance
Recognition of liabilities for possible future claims	Reflecting future investment margins, with exceptions	To keep liabilities on balance sheet until discharged, cancelled or expired.
Offsetting of reinsurance assets and direct liabilities	Measuring rights to the future investment management fees	
	Recognition of DAC	
	Subsidiaries using non-uniform accounting policies	

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Measurement for insurance contracts
Prohibited policies

The following accounting policies are prohibited

- Amounts for catastrophe or equalisation provisions for potential claims beyond the term of existing contracts
  - **Catastrophe provisions** are provisions that are generally built up over the years out of premiums received, usually following a prescribed formula, until a specific limit is reached. They are usually intended to be used on the occurrence of a future catastrophic loss that is covered by current or future contracts of this type.
  - **Equalisation provisions** are usually intended to cover random fluctuations of claim expenses around the expected value of claims for some types of insurance contract (such as hail, guarantee and fidelity insurance) using a formula based on experience over a number of years. In some jurisdictions the premiums for catastrophe and/or equalisation reserves is required to be segregated and is not available for distribution to shareholders.
  - SLFRS 4 prohibits the recognition of any liabilities for possible future claims, if these claims arise from insurance contracts that are not in existence at the reporting date (such as catastrophe and equalisation provisions) because such provisions are not liabilities as defined in the framework because the insurer has no present obligation for losses that will occur after the end of the contract period . *(IFRS 4, para. 14(a)).*
  - Offsetting of reinsurance assets and direct liabilities

SLFRS 4 –Insurance Contracts
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Measurement for insurance contracts
Mandated policies

The following accounting policies are mandated if they are not already present

Impairment of reinsurance assets

Liability adequacy testing. SLFRS 4 specifically requires an insurer to assess, at each reporting date, whether its insurance liabilities are adequate using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of the insurer's insurance liabilities (less related deferred acquisition costs and related intangible assets) is inadequate in the light of the estimated future cash flows, the entire deficiency shall be recognised in profit or loss.

Reinsurance Asset- A cedent's net contractual rights under a reinsurance contract

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Measurement for insurance contracts
Mandated policies-Liability Adequacy Testing

- Recognition of future losses required
- A deficiency is indicated when future cash flows exceed the net carrying amount
- For insurance contracts, existing liability adequacy tests apply unless they fail to meet the IFRS 4 minimum requirements, in which case an SLAS 36-Provisions, contingent assets and contingent liabilities measure apply

Liability Adequacy Test- An assessment of whether the carrying amount of an **insurance liability** needs to be increased (or the carrying amount of related deferred acquisition costs or related intangible assets decreased), based on a review of future cash flows.

Current Estimates of Futures Cash Flows = Future Premiums − Future Claims (including considering options & guarantees) − related DAC − related Intangibles

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Measurement for insurance contracts
Deferred acquisition costs (DAC)

- SLFRS 4 does not address accounting for acquisition costs. It neither prohibits nor requires the deferral of acquisition costs, not does it prescribe what acquisition costs are deferred, the period and method of their amortisation or whether an insurer should present deferred acquisition costs as an asset or as a reduction in insurance liabilities. This is due to the fact that the treatment of acquisition costs is regarded as an integral part of existing models and cannot be more easily amended without a more fundamental review of these models in Phase 2.

- Insurers are therefore permitted to continue to apply their existing accounting policies to deferred acquisition costs arising from insurance contracts.

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Measurement for insurance contracts
Re-insurance

- Any gains or losses at inception should be disclosed at issue and over the life time of a reinsurance treaty
- If the cedent's reinsuracne asset is impaired the cedent is required to reduce the carrying amount accordingly and recognise the impairment loss in the P&L.
- Cedants will only need to recognise reinsurance impairments if and only if there is objective evidence of an event that gives rise to the likelihood of receiving the full reinsurance balance.
- Reinsurance that does not contain significant insurance risk, such as financial reinsurance, is classified as a financial instrument that falls within the scope of LKAS 39.

Re-insurer –The party that has an obligation under a **reinsuracne contract** to compensate a **cedent** if an insured event occurs

Reinsuracne Contract- An insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the **cedent**) for losses on one or more contracts issued by the **cedent.**

Cedent-The policy holder under a reinsurance contract.

IFRS 4 -Measurement for Investment contracts

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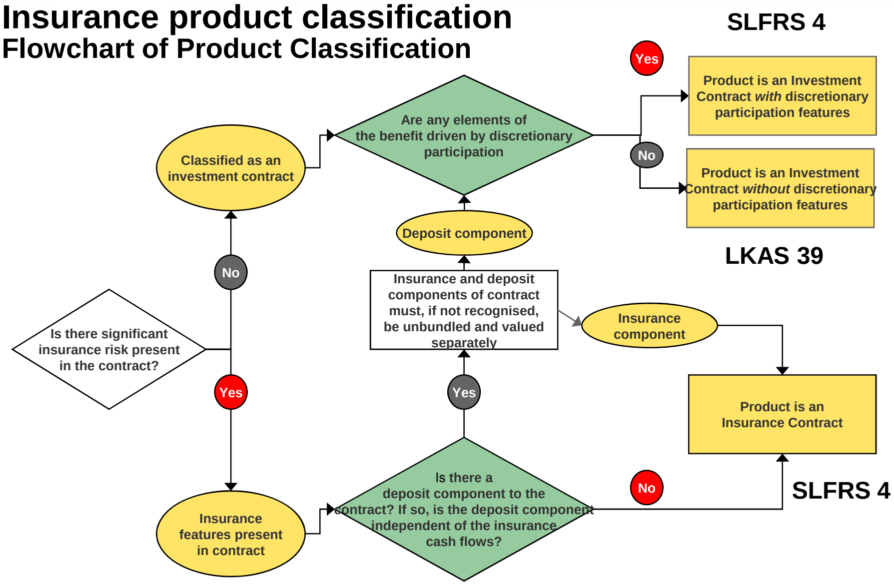
Insurance product classification
Flowchart of Product Classification



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Measurement for investment contracts
Unbundling of deposit components

Certain contracts contain both an insurance component and a 'deposit component'. In order to get consistent accounting treatment for each element, the contracts <u>may need to be unbundled.</u>

Unbundling is intended to require recognition of deposit elements of contracts that in some accounting regimes were not reflected. It has the following accounting consequences:

1. the insurance component is measured as an insurance contract;
2. the deposit component is measured under LKAS 39 at either amortised cost or fair value.
3. premium receipts for the deposit component are not recognised as revenue, but rather as changes in the deposit liability. Premium receipts for the insurance component are typically recognised as revenue; and
4. deferrable acquisition costs at inception is required to be separately calculated for insurance contract components and deposit components by applying SLFRS 4 and LKAS 18 respectively. This may have a material effect on the income statements as LKAS 18 poses more restricted requirements in terms of what constitutes deferrable costs whereas SLFRS 4 is unclear about which transaction costs can be capitalised for an insurance contract.

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Measurement for investment contracts
Unbundling of deposit components

So when do you unbundle?

Unbundling is required only if both the following conditions are met :

- The insurer's existing accounting policies do not require recognition of the deposit component and
- The insurer can independently measure the deposit component from the insurance component

Unbundling is allowed but not required when the insurer only meets the second condition that the insurer can independently measure the deposit component from the insurance component.

It means unbundling may be required when insurance benefit cash flows do not affect the deposit-like cash flows at all. If any grey areas exist, or if there are difficulties in unbundling, then do not unbundle.

Unbundle- Account for the components of a contract as if they were separate contracts

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Measurement for investment contracts
Summary of accounting treatment for investment contracts

- Contracts that fail to meet the definition of an insurance contract are likely to be financial instruments falling under LKAS 39 which are often known as investment contracts.
- Investment contracts without DPF will apply LKAS 39 and LKAS 18 and are classified as financial liability (like a deposit). They are valued at amortised cost or fair value under LKAS 39.
- Income previously taken up front on contracts (eg. bid/offer spreads, establishment charges) is **deferred** over the life of contract to match against associated services provided (LKAS 18).
- Initial acquisition costs deferrable **are restricted** to those that are incremental to each policy sale (mostly commissions). This represents an intangible asset for the right to charge customers for investment management services (LKAS 18). This means less costs are deferrable than under insurance DAC as SLFRS 4 does not specify what constitutes deferrable acquisition costs (refer to section 2 Measurement for insurance contracts). The restrictive requirements result in higher expense charges to income when contracts are sold but lower amortisation in future years.
- Premiums and claims are no longer allowed to be recognised in income statement but replaced by margins (eg. initial charges, annual management charges) as income items. However, the change only affects presentational adjustment with no impact on overall net income.

Changes in Accounting Policies.

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Changes in Accounting Policies

- An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An insurer shall judge relevance and reliability by the criteria in LKAS 8

SLFRS 4 –Insurance Contracts
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Changes in Accounting Policies

Current market interest rates

- An insurer is permitted, but not required, to change its accounting policies so that it remeasures designated insurance liabilities to reflect current market interest rates and recognises changes in those liabilities in profit or loss.
- At that time, it may also introduce accounting policies that require other current estimates and assumptions for the designated liabilities. The election in this paragraph permits an insurer to change its accounting policies for designated liabilities, without applying those policies consistently to all similar liabilities as LKAS 8 would otherwise require. If an insurer designates liabilities for this election, it shall continue to apply current market interest rates (and, if applicable, the other current estimates and assumptions) consistently in all periods to all these liabilities until they are extinguished.

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Changes in Accounting Policies

Continuation of existing practices

- An insurer may continue the following practices
  - measuring insurance liabilities on an undiscounted basis.
  - measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services. It is likely that the fair value at inception of those contractual rights equals the origination costs paid, unless future investment management fees and related costs are out of line with market comparables.
  - using non-uniform accounting policies for the insurance contracts (and related deferred acquisition costs and related intangible assets, if any) of subsidiaries If those accounting policies are not uniform, an insurer may change them if the change does not make the accounting policies more diverse and also satisfies the other requirements in this SLFRS.

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Changes in Accounting Policies

Shadow accounting

- In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of
  - its insurance liabilities,
  - related deferred acquisition costs and
  - related intangible assets,
- An insurer is permitted, but not required, to change its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) shall be recognised in other comprehensive income if, and only if, the unrealised gains or losses are recognised in other comprehensive income.
- This practice is sometimes described as 'shadow accounting'.

Expanded Disclosures.

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Expanded Disclosures

- Significant increase in qualitative and quantitative disclosures for insurance and investment contracts
- Disclosures include explanation of reported results, amount, timing and uncertainty
- Risk management objectives, material terms and conditions, sensitivity analysis and concentrations.
- Interest and credit risk on reinsurance arrangements
- Claims development triangles
- Analysis of movement in reserves
- Additional income and balance sheet financial disclosures
- Disclosure of significant reserves held in equity.

Managing the Transition

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Business considerations

- Additional complexity in Finance processes and system calculations
- Better communication and alignment between the Investment function and Finance is required – the business activity should reflect the accounting classification and vice versa
- Certain funding instruments less attractive
- Greater balance sheet and potentially greater P&L volatility
- Actuaries and accountants need to work closer to source and calculate additional risk related disclosures
- Product development teams need to be aware of changes, in particular for product classification and guarantees

Thank You.