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The New IFRS Insurance Accounting Proposals: Implications for Canadian Workers Compensation Boards

This bulletin summarizes the key provisions of the IASB's revised Exposure Draft *Insurance Contracts*, issued June 2013, and their implications for Canadian Workers Compensation Boards and similar organizations.

After years of study, deliberations and vigorous debate, the re-exposure draft of the IFRS *Insurance Contracts* standard was released on June 20. It is expected that after a fairly brief comment period ending on October 25, a global insurance accounting standard will finally be released in late 2014 or early 2015. The new standard is expected to be mandatorily effective approximately three years after the final standard's release, which would be no earlier than 2017, and more likely for years beginning on or after January 1, 2018.

In the month following the release of the new Exposure Draft, the IASB also announced its intention to indefinitely defer the effective date of revised classification and measurement rules for financial instruments under IFRS 9, pending the finalization of the impairment and classification and measurement requirements. It is hoped that this delay will allow the implementation date of these standards to be aligned with the implementation of the new insurance accounting rules.

Upon adopting IFRS in 2011, the existing IFRS 4 Insurance Contracts standard allowed Canadian insurers, including Workers Compensation Boards (WCBs), to continue their past practices for accounting for benefit liabilities without substantial changes. The replacement standard is expected to have significant effects on the measurement and reporting of benefit liabilities and the net funding positions of WCBs, particularly taken together with changes to investment accounting rules as a result of the expected changes in financial instruments accounting under IFRS 9.

Canadian WCBs should carefully analyze the new proposals to prepare their organizations, governance bodies and stakeholders for the changes in financial reporting, and how they will affect the assessment of operating results, premium adequacy and funding levels.

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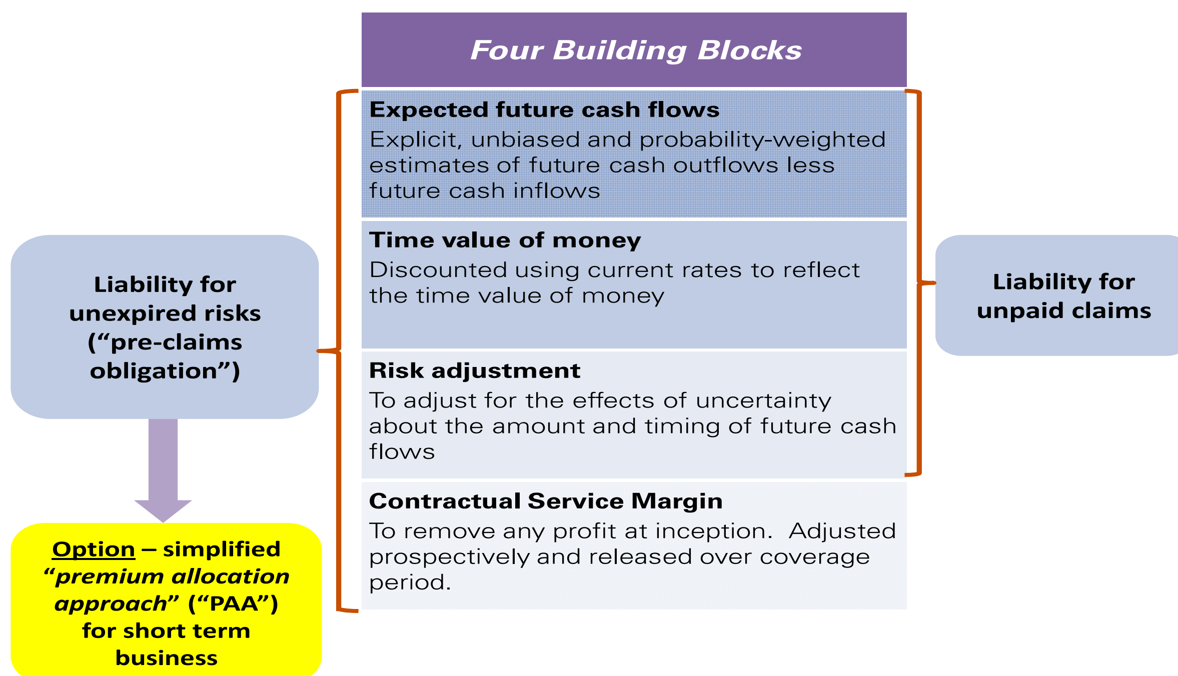
The proposed new measurement model for insurance

The basic model of the new IFRS proposals reflects a "4 building blocks" approach:



Insurance contract liabilities are composed of a liability for the unexpired coverage period (the "pre-claims obligation"), and a liability for incurred claims or benefits payable. Under this model, an insurer would measure its liability for the remaining coverage period using the "4 building blocks", and it would record the liability for claims incurred using only the first three building blocks (expected cash flows, discounted for the time value of money, plus a risk margin) since the residual or contractual service margin does not apply. This model accommodates the full range of insurance contracts, including complex contracts that may provide coverage over a period of many years, and involve significant future premiums and changes in risks.

In order to accommodate simpler insurance contracts, particularly those with short terms of coverage, the IFRS proposals also include a simplified "Premium Allocation Approach" (PAA) which can be used to estimate the liability for the remaining coverage period. This is permitted for coverage periods of one year or less, and where the measurement is a reasonable approximation of what would result from applying the full "4 building blocks" model.

Most Canadian WCB coverages would appear to be eligible for the Premium Allocation Approach, as they are commonly structured on a calendar year basis, with the WCB having the ability to revise premium rates annually. It appears likely that most WCBs will find the PAA an attractive choice, due to its simplicity and since it has little or no difference from current premium accounting practices. WCB coverages are typically short term and with premiums collected somewhat in arrears rather than in advance, with little or no "unearned premium" liability recorded under current practices. Accordingly, the insurance contracts liability would continue to be primarily or even entirely composed of the benefits liability ("liability for unpaid claims").

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The determination of benefit liabilities would be the same under both the full “4 building blocks” model and under the Premium Allocation Approach.

Measuring benefit liabilities

Actuarial standards applicable to WCBs have been less prescriptive than those developed for other life and general insurers. Benefit liabilities have reflected the best estimate of the present value of benefit costs for Incurred claims, and additional provisions for actuarially-determined margins for adverse deviation have been permitted but not required. Discount rates used to calculate present values have reflected long term expectations of investment returns. The new IFRS proposals will narrow the range of acceptable practice and will likely result in an increase in recorded benefit liabilities:

Impact on Canadian WCBs

Component of Benefit Liabilities	***Change in Practice for WCBs?***	***Directional impact?***
Expected future cash flows for benefits would reflect explicit, unbiased, probability-weighted estimates of future cash flows directly attributable to the benefits; this would include future claims administration expenses.	*Minimal or no change*	*Probably minimal or no change* • allocated future claims administration costs should be reviewed for indirect fixed costs that do not meet the definition of costs to be provided for in liabilities • provisions for occupational disease exposures would be applicable, while still somewhat subjective
Time value of money would be reflected by discounting expected future cash flows. The discount rate would reflect market discount rates, rather than the rate of return expected on the entities assets.	*Significant* Past Canadian actuarial practice has been to use a discount rate reflecting a rate of return on the insurer’s own assets, somewhat similar to discount rates used for pension plans. The proposals allow either a “bottom-up” approach starting with risk-free rates, or a “top-down” approach starting with an investment asset rate and deducting investment margins that are not relevant to the liability. The proposed standard also refers to the discount rates as based on a yield curve rather than a single average rate.	*Significant increase possible* • Lower discount rates could result for some WCBs, resulting in higher benefit liabilities. • A range of practice is permitted in determining discount rates, but in general, discount rates would be lower than an expected asset portfolio return, since starting with the latter in a “top-down” approach would require removing margins for investment risks such as credit losses and other investment margins. • Detailed disclosure of the discount rates used would be required.

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An explicit risk margin would be required to adjust for the effects of uncertainty in the amount and timing of cash flows.	*Significant* Such margins have permitted but not required under past WCB standards, unlike those applicable to other insurers. The proposed risk margin relates only to the amount and timing of cash flows to satisfy the benefit obligations. Past Canadian actuarial practice for other insurers has included other asset-related and mis-match factors in provisions for adverse deviation.	*Significant increase possible* • Except for any WCB that voluntarily made provisions for adverse deviations in the past, a significant increase in benefit liabilities may result. • The method of determining the risk margin is not prescribed, but disclosure of the confidence level inherent in the liability is required; e.g. "the benefit liabilities are estimated to be established at a 70% confidence level", promoting comparison to other organizations. (Note that without the risk margin, the benefit liability could be said to be at the 50% level of confidence, meaning that half the time it is expected that the provision is sufficient to cover the actual benefits required.)
Re-measurement of liabilities - benefit liabilities would be re-estimated to reflect current best estimates of all assumptions.	*No change*	*No change*

Reporting changes in benefit liabilities

Under the proposals, changes in estimates of WCB benefit liabilities would generally be recognized in comprehensive income immediately, as is the case under existing practice. However, the proposals differentiate between changes due to discount rates and changes due to other factors.

Much of the debate about the IFRS insurance contracts proposals has related to the volatility that would be expected as a result of changes in the interest rates used to discount liabilities, particularly as a result of disconnecting the valuation of liabilities and investment assets. In response, the IASB has introduced what has been referred to as the "two-sided OCI solution". These proposals remove from the income statement the changes in the measurement of assets and liabilities resulting from interest rate fluctuations.

- *Benefit liabilities* - the liabilities would be calculated using current discount rates, and changes in the liabilities resulting from a difference in the discount rate "locked in" when the contract is first recognized would be recorded in other comprehensive income (OCI)
- *Investments in qualifying debt instruments* - these assets would be recorded at fair value, and changes in fair value from changes in market interest rates would be recorded in other comprehensive income (OCI), similar to the current available-for-sale (AFS) classification

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- *Other investments* - other investment assets would not have directly measurable accounting changes due to interest rate movements, and would be accounted for either at amortized cost, at fair value with changes in values recognized in profit and loss (FVTPL), or with some limitations for equities, fair value through OCI (FVOCI)

The proposals *require* changes in the insurance liability arising from changes in discount rates to be recognized in OCI regardless of the classification and measurement applied to the insurer's assets. Qualifying debt instruments would be required to be classified as FVOCI, unless classification as FVTPL would reduce or eliminate an accounting mis-match. This condition for use of FVTPL would be difficult to achieve for insurers, given the mandatory use of OCI for liability valuation changes due to interest rates.

Impact on Canadian WCBs

The "two sided OCI" solution to remove interest-related volatility from the income statement has been welcomed by many insurers as an effective tool to exclude interest-related volatility from earnings, so that operating results are not obscured by what may be short term swings in market interest rates. However, this approach does not address other accounting mis-matches that can arise from value changes in equity and property investments, which are a significant portion of the assets held by WCBs. Furthermore, "parking" the volatility in other comprehensive income will not change the effects of interest rate volatility on the overall equity or "funded" position.

The use of OCI may put greater emphasis on distinguishing between the statement of income, and the statement of comprehensive income. The statement of income would exclude interest-related volatility, and WCBs wishing to emphasize this separation may consider having a separate statement of income and statement of comprehensive income.

The "two sided OCI" approach will also add to complexity of calculations, as it will require organizations to track the locked-in initial discount rates for liabilities in order to calculate the amounts to be recorded in OCI.

Interaction with accounting for investments

In order to achieve the asset side of the "two sided OCI" solution, the IASB has proposed to revise IFRS 9 so that debt instruments consisting solely of payments of principal and interest would be subject to FVOCI classification (fair value through other comprehensive income - similar to the current Available for Sale (AFS) category) if they are held within a business model whose objective is to both hold financial assets to collect contractual cash flows and to sell financial assets. This would likely apply to conventional bond portfolios, for bonds that do not include other features such as embedded derivatives. Bonds with significant embedded derivatives would not be eligible for FVOCI classification, and would be classified as fair value through profit and loss (FVTPL).

- *Some WCBs currently designate most of their investment assets as FVTPL. This provides a reasonable approach to good accounting matching since both the investment valuation changes and the changes in liabilities due to discounting are recorded through current income. Under the proposals, investments in qualifying debt instruments, particularly bonds, would be re-designated as FVOCI.*

Limiting assets eligible for FVOCI to debt instruments may be less attractive for WCBs that use non-financial assets ("NFIs", such as equities and property) to support benefit liabilities. Market volatility in the carrying value of these assets would be immediately recognized in profit and loss, resulting in a mis-match in reported earnings.

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The FVOCI category would also be available for equity investments, with the limitation that realized gains on the equities would not be recognized (or "recycled") to profit and loss, but would remain in accumulated other comprehensive income (AOCI).

- *This limitation will likely make use of FVOCI for equities unattractive for private sector insurers with a greater focus on net income. Some WCBs might consider this approach, since excluding equity volatility from current income might be attractive in reporting on current operating performance. Although realized gains would not be reflected in net income, they would still be reflected in OCI and total comprehensive income, and included in the overall funded position, which includes AOCI.*

Effective date - July 2013 IASB announcements

The existing IFRS 9 standard was to be mandatorily effective for years beginning on or after January 1, 2015, and the proposed changes to classification and measurement rules to accommodate the "two sided OCI" approach were intended to be included in the revised IFRS 9 in time for 2015. However, other changes in the financial instruments accounting standards related to hedge accounting and asset impairment are not yet finalized, and numerous representations have been made to the IASB that 2015 implementation would be premature in the circumstances.

In the July 2013 IASB meeting, the IASB tentatively decided to defer the effective date of IFRS 9 indefinitely, pending the finalization of the impairment and classification and measurement requirements.

- *While no new implementation date has been announced, the deferral of IFRS 9 may result in this standard being implemented at the same time as the new insurance accounting rules, which was the original stated intention of the IASB. This would be welcomed by many insurers, who would otherwise have to implement two significant changes in different years, for standards where the implementation considerations are significantly inter-related.*

Further information

The above is a summary of provisions of particular interest to Canadian Workers Compensation Boards and similar organizations. For further information, please contact the authors of this publication:

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For a more complete analysis of the proposed standard, please refer to the July 2013 KPMG publication ***New on the Horizon: Insurance Contracts,*** which is available from your KPMG contact or by download from:

http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/New-on-the-Horizon/Pages/NOTH-insurance.aspx

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