Accounting under IFRS

Life Insurance Industry

February 13, 2009

Agenda

Product classification

Accounting for investments

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Product classification

Accounting for investments

Need for product classification

- IFRS 4: Only standard on insurance contracts
- Applies only to contracts that meet the definition of an insurance contract
  - Investment contracts not meeting this definition covered under IAS 39 on `Financial Instruments: Recognition and Measurement'
- Classification of products into insurance products or otherwise: a *prerequisite* under IFRS

Definition of an insurance contract

- **Definition refers to traditional features of insurance contracts, distinguishing them from financial contracts**
- **Definition:**

  "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"

  - **Insurance risk is defined as a *transferred risk* other than *financial risk***

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#1: Significant insurance risk

- Quantitative guidance for assessing *significance* of insurance risk not provided
- Contract is an insurance contract if it results in a significant additional payment
  - If in a contract, death benefit exceeds the amount payable on survival, the contract is insurance contract unless the additional benefit is insignificant
- Significance is interpreted in relation to an individual contract; except in a portfolio of homogenous contracts

#1: Significant insurance risk (Contd.)

- Some contracts do not transfer any insurance risk to the issuer at inception, although they do transfer insurance risk at a later time
  - Account for as investment contract until transfer of the insurance risk
  - Once the insurance risk is transferred account for as insurance contract

  Example: a zero death benefit pension product

- An insurance contract remains as an insurance contract until all rights and obligations are extinguished or expire

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#2: Uncertain future event

- Uncertainty of the insured event can result from uncertainty over:
  - the occurrence of the event;
  - the timing of the occurrence of the event; or
  - the magnitude of the effect, if the event occurs
- Insured event must be explicitly or implicitly described

#3: Transferred risks

- Refers to risks which were pre existing for the policyholder at inception of the contract
  - Loss of future earnings for the insured, when the contract is terminated by the insured event, is not insurance risk as the economic loss for the insured is not a transferred risk

#4: Financial risks

- Include the risk of a possible change in variables such as
  - interest rate
  - financial instrument price
  - commodity price
  - foreign exchange rate
- Financial risk products are not presently sold by Life Insurance Companies in India

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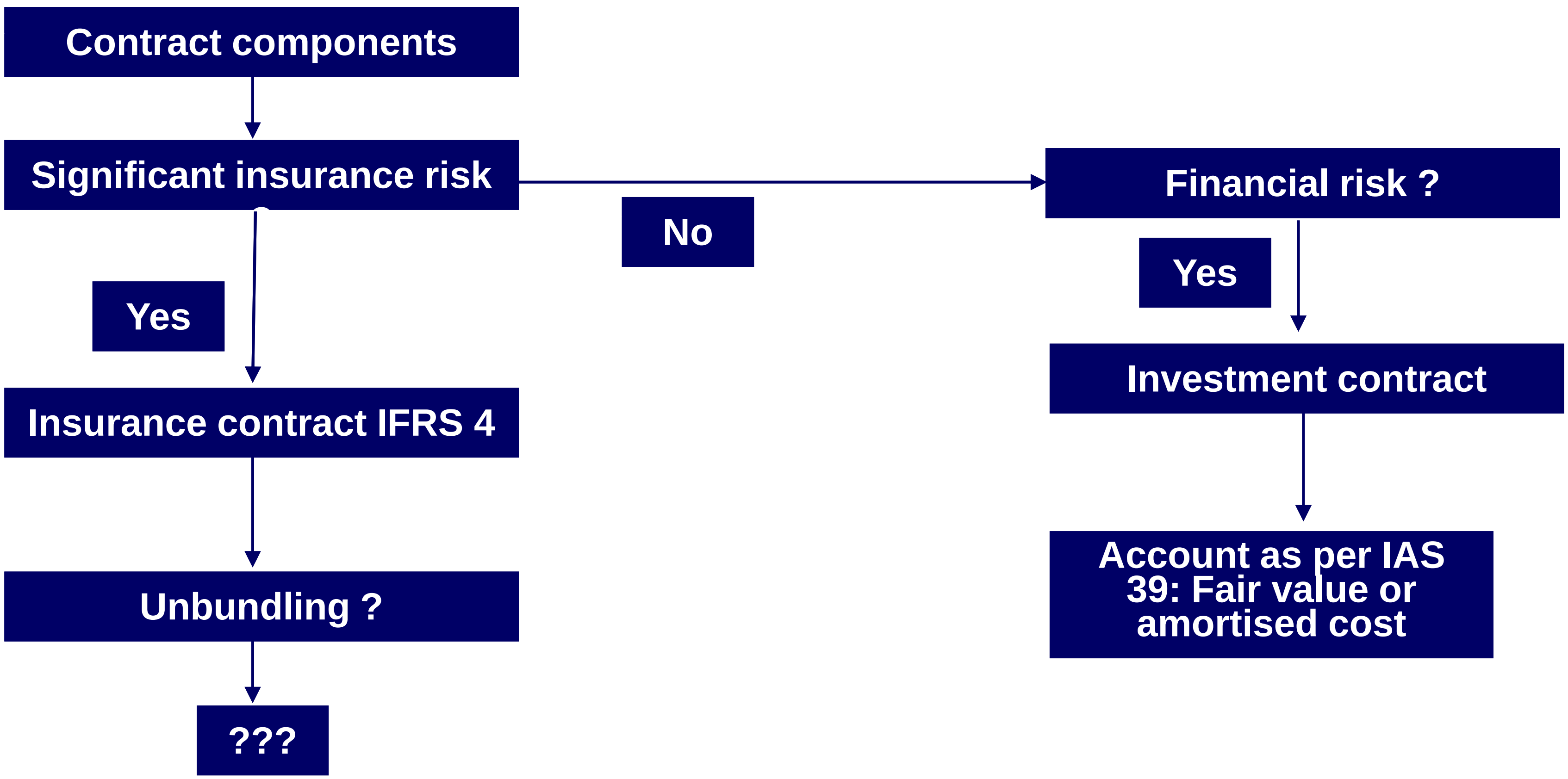
Definition of an insurance contract

- **“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”**
    - **Insurance risk is defined as a *transferred risk* other than *financial risk***

Accounting of Insurance contracts



Unbundling of an insurance contract

Can the insurer measure the deposit component separately without considering the insurance component ?

No

Unbundling prohibited

Yes

The insurer's accounting policies require it to recognize all obligations and rights arising from the deposit component

Yes

Unbundling permitted

but not required

No

Unbundling required

Unbundled

Yes

Deposit element: Account as per IAS 39 (Fair value or amortised cost)
Insurance element: Account as per local GAAP

No

Account as per local GAAP

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Indicative contract classification: Indian context

Product portfolio	Classification
Unit Linked life	Insurance contracts as IRDA mandates a minimum death cover of 5 times the premium
Unit Linked pension	Insurance or Investment contracts depending on sum assured opted
Participating – non linked life & endowment products	Insurance or Investment contracts depending on sum assured opted
Participating – endowment pension	Insurance or Investment contracts depending on sum assured opted
Non participating: Term (retail & group), Mortgage & Credit term and Health products	Insurance contracts
Group Superannuation, Gratuity & Leave encashment	Investment contracts

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Implications for Insurance Company

- To unbundle or not?
  - Transparency?
  - Impact on top line
- No quantitative guidance on identification of significant insurance risk
  - Open to individual judgment in identifying significance of insurance risk
  - Internationally contracts where the risk cover exceeds the premium by over 5 -10% are classified as Insurance contracts

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Agenda

Product classification

Accounting for Investments

Investment accounting – Indian context

- **Investments**
  - **Linked**
    - Valued at fair value; unrealised gain/loss is taken to Revenue account
  - **Non Linked & Shareholders**
    - **Equity & Mutual Fund Investment**
      - Valued at fair value; Unrealised gain/ loss taken to Balance Sheet
    - **Other Investments including debt instruments**
      - Valued at amortised cost using simple interest rate method

Investment accounting – under IFRS

- **Recognition and measurement of Investments under IFRS governed by IAS 39 - `Financial Instruments: Recognition and Measurement’**
- **IAS 39 prescribes rules for:**
  - **Recognition (and de-recognition) of financial instruments**
  - **Measurement of various types of financial instruments in the financial statements, including derivative financial instruments**
  - **Hedge accounting**

Recognition and De-recognition

- **Recognition: only when entity becomes party to the contractual provisions of the instrument**
- **De-recognition: is appropriate if either one of these two criteria is met:**
  - **Contractual rights to the cash flows of the financial asset have expired, *or***
  - **The financial asset has been transferred and the transfer qualifies for de-recognition**
- **In Indian GAAP, presently there are no explicit guidelines on the timing of recognition & de-recognition of investment**

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Measurement of financial instruments

Fair value through profit and loss	Held-to-maturity assets (HTM)	Loans and receivables	Available for sale financial assets (AFS)
I. Classification requirements:			
a. Held for trading (acquired for the purpose of short-term profit taking)	a. Fixed or determinable payments and fixed maturity with intention to hold till maturity	a. Financial assets with fixed or determinable payments	Financial assets not classified in any of the other categories
b. Upon initial recognition, designated as fair value through profit or loss	b. If the portfolio has been tainted, then financial assets cannot be classified as HTM	b. Not quoted in an active market	
II. Initial measurement (at the time of purchase):			
Fair value	Fair value + acquisition cost		

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Measurement of financial instruments (Contd..)

Fair value through profit and loss	Held-to-maturity assets	Loans and receivables	Available for sale financial assets
III. Subsequent measurement:			
Fair value	At amortised cost using effective interest rate method		Fair value
IV. Recognition of gains / losses through change in fair value:			
Recognised in profit or loss account	Not applicable		To be recognised in the equity account (i.e. the reserves and not through profit or loss account)

Measurement of financial instruments (Contd..)

Fair value through profit and loss	Held-to-maturity assets	Loans and receivables	Available for sale financial assets
V. Impairment loss:			
Not applicable as any gains/losses are already recognised in the profit or loss account	Amount of loss: difference between the assets carrying amount and the present value of estimated future cash flows		Amount of loss: the difference between the acquisition cost and the current fair value
	Recognition: loss shall be recognised in the profit or loss account and the carrying value of the financial asset shall be accordingly reduced		Recognition: the cumulative loss previously recognised shall be reduced from the equity (reserves) account and shall be recognised in profit or loss account

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Measurement of financial instruments (Contd..)

- **Other aspects on measurement:**
  - **Amortisation basis**
    - **IFRS prescribes *Effective interest method***
    - **Indian GAAP prescribes *current simple interest method***
  - ***Transaction costs* (related to acquisition / issuance of investment)**
    - **IAS 39 prescribes the cost to be charged off to the Revenue / Profit & Loss Account**
    - **Indian GAAP prescribes capitalisation of the cost with the cost of investment**

Re-classification of financial instruments

- An investment cannot be classified into or out of fair value through profit or loss category
- Reclassification between AFS & HTM categories is possible
  - Except if HTM portfolio is tainted
  - If significant amount is reclassified under AFS from HTM; the remaining HTM investment has also to be reclassified into AFS

Implications for Insurance Company

- Alignment between IRDA regulations and requirements of IAS 39
- Classification of investments in light of lack of experience
- Volatility in the revenue account if one classifies Investments as Fair value through Profit & Loss
- Decision to classify investments either at fund, segment or at each security level
  - This could impact allocation of a single security across various funds having different classification categories

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Implications for Insurance Company

- **Stringent tainting provisions:**
  - **Companies would be forced to classify long term securities as other than HTM category**
- **HTM securities will now be valued using effective interest method as against presently used simple interest method, requiring necessary system changes**
- **System readiness in respect of accounting, valuation and providing other disclosure related information**

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Thank you

Back-up slides

Financial risks: non financial variables

- **Examples of non–financial variables not specific to a party to the contract and therefore included in the definition of financial risk**
  - **Mortality rates of a population;**
  - **Claims indices of an insurance market**

- **Examples of non–financial variables specific to a party to the contract and therefore excluded from the definition of financial risk**
  - **The claims index, cost or lapse rate of that party;**
  - **The state of health of the party**

Classification of products: Indian context

- **Product classification for broad category of products currently existing in India is attached herewith for reference**

Product
classification

Investment accounting – under IFRS

- **Financial instrument refers to any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity**
  - **In this definition, *contract* refers to an agreement between two parties that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. An asset or liability that is not contractual (e.g., an obligation to pay income taxes) is not a financial instrument even though it may result in the receipt or delivery of cash**
- ***Financial asset* refers to any asset that is**
  - **Cash;**
  - **An equity instrument of another entity; or**
  - **A contractual right to receive cash or another financial asset from another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or**
  - **A contract that may or will be settled in the entity's own equity instrument and is not classified as an equity instrument of the entity**

Investment accounting – under IFRS

- ***Financial liability*** **refers to any liability that is**
  - **A contractual obligation to deliver cash or another financial asset to another entity; or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or**
  - **A contract that will or may be settled in the entity's own equity instruments and is not classified as an equity instrument of the entity**
- ***Thus IAS 39 is not restricted to Financial Instruments currently held as Investments. But also applies to:***
  - **Other financial assets like cash, deposits, receivables, loans, et**
  - **Financial liabilities like payables, deposits, loans, other debt instruments issued by the entity etc**
  - **Derivative financials instruments like call options, put options, forwards, futures, swaps etc**