

Insurance Accounting Alert

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IASB holds further discussions on participating contracts

What you need to know

- ▶ The IASB continued its discussions on contracts with participation features. No decisions were made.
- ▶ Board members provided feedback on several key topics related to contracts with participation features; this feedback will shape the further development of the proposals.

Overview

During its May meeting, the International Accounting Standards Board (IASB, or Board) continued redeliberations on its 2013 Exposure Draft *Insurance Contracts* (ED) with an education session on possible adaptations to the building block approach (the general model) for contracts with participation features (participating contracts). This session expanded on the proposals made at previous meetings for a variable fee approach for certain qualifying participating contracts. Several complex questions were debated around qualifying participating contracts issues, including:

- ▶ The level of aggregation of contracts - particularly where 'mutualisation' exists
- ▶ How to present revenue in the Statement of Comprehensive Income for contracts in scope of this approach
- ▶ Transition from existing accounting

In addition, the Board also considered the accounting for other types of participating contracts ('indirect participation' contracts) that do not qualify for the variable fee approach.

The Board also discussed whether, for participating contracts, an accounting policy choice should be provided to report changes in discount rates either in profit and loss or in OCI.

The staff provided the Board with an update on feedback received relating to the interaction between IFRS 9 *Financial Instruments* and the Insurance Contracts project.

The story so far

The IASB's website provides information about tentative decisions made on the insurance contracts accounting model, and discussions prior to this meeting, including:

- ▶ The cover note for the Insurance board papers for the May meeting which contains a summary of progress so far¹
- ▶ Further information on the project and the proposed model²

¹ <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/May/AP02-Insurance-Contracts.pdf>

² <http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Insurance-Contracts.aspx>



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Application of the variable fee approach

Level of aggregation and mutualisation

The staff clarified that the Board's previous decision that the level of aggregation for the contractual service margin (CSM) is at individual contract level applies equally to participating contracts, including those that would be in scope of a variable fee approach. Entities may aggregate contracts as long as they expect that, in doing so, they will meet the objective of the standard to measure contracts at an individual contract level.

The staff reminded the Board of the mechanics of the variable fee approach. Under the variable fee approach, a participating contract would be considered to create an obligation for the entity to pay the policyholder an amount equal to the value of the underlying items, net of a consideration charge for the contract. Accordingly, the entity's interest would represent a variable fee for the service of managing the items on behalf of a policyholder. To the extent the value of the underlying items matches the obligation to the policyholder, this fee is an underwriting result reported through the CSM release. Subsequent changes to the expected fee resulting from changes in the value of underlying items would be adjusted against the CSM to reflect the change in the expected value of the future services (i.e., unlocking of the CSM). Under the variable fee approach, entities would only be permitted to reflect in CSM the value change related to changes in the value of specified underlying items. Accordingly, if an entity chooses to invest in alternative assets and not those directly related to the promised return, any change from the return on those alternative assets would be an investment return based on the entity's actual investment strategy. Therefore, the only element from underlying items reported as a net investment result would be the difference between the return on the actual assets held by the entity and the obligation to the policyholder from the return on the underlying items. The staff will ask the Board whether to adopt a variable fee approach at a future meeting.

The staff explained that some participating contracts within the scope of the variable fee approach contain a contractual feature that results in some policyholders in a pool of contracts sharing the risk relating to returns from underlying items with other policyholders in the same pool. This feature reduces the direct exposure of the insurer to the risk that the underlying items will not generate sufficient returns to pay guaranteed benefits to another group of policyholders specified under the contract. This feature is referred to as 'mutualisation'.

Some board members queried whether mutualisation, particularly across generations, would drive an overly high level of aggregation, which could affect the measurement of the contractual service margin and timing of recognition of underwriting gains and losses in profit or loss. The staff clarified that mutualisation would result in losses not being recognised from an obligation to pay a specific group of policyholders only if another group of policyholders bears these losses. According to the staff, mutualisation should not override the objective of the standard and other criteria for aggregation of the CSM even where other generations bear the losses. The staff is not proposing to prescribe how entities should ensure the principle of aggregation is satisfied.

The staff emphasised that mutualisation should be distinguished from: (i) risk diversification; and (ii) the exercise of discretion over the amounts of returns passed on to policyholders, without the same contractual obligations as in mutualisation. On (i), Board members agreed that mutualisation is not the same as risk diversification. On (ii), there was some discussion as to whether discretion in some circumstances should affect the application of mutualisation. The staff clarified that it does not consider management discretion to set profit sharing levels for two unrelated pools of contracts to be reflective of mutualisation between those two pools.

One Board member questioned whether it was necessary to limit mutualisation to contracts that are in the scope of the

variable fee approach only. In the view of this Board member, there would not be a conceptual reason to exclude contracts that do not share a substantial portion but more than a certain minimum portion of the returns on underlying items. The staff acknowledged this point and will investigate the possibility of applying mutualisation to contracts that are outside the scope of a variable fee approach.

The Board considered potential additional disclosure on the effects of mutualisation. One Board member stated that disclosure would forewarn of potential material future losses. Without it, if losses on an individual contract are borne by other policyholders in the group, and the level of aggregation takes into account mutualisation, these losses may only be reported in profit or loss when the entire group of policyholders can no longer absorb the loss. Other Board members countered that losses absorbed through mutualisation by other policyholders are simply reflecting the expected value measurement model and the Board did not require disclosure of losses on individual policyholders that are not considered losses to the entity under the measurement model. Staff suggested that risk disclosures may provide a more appropriate picture, but would consider further disclosures such as the nature of guarantees issued to policyholders.



Revenue for contracts in variable fee approach

The staff did not find any reason to suggest a different approach to recognition of revenue for participating contracts compared with that for other insurance contracts. It is expected that for most participating contracts premiums and claims amounts would contain substantial investment components which will need to be presented outside the Statement of Comprehensive Income. The staff indicated that identifying and separately accounting for these components should not be onerous.

The Board was reminded that the proposed insurance model does not include a constraint on variable consideration similar to the one in IFRS 15 *Revenue from Contracts with Customers*, because this would not be consistent with the expected value model for insurance contracts. One Board member noted that this constraint, if it would be applied to the insurance contracts model, could result in an insurance entity not recognising any revenue or profit until a contract had reached the end of the coverage period.

Transition for contracts in variable fee approach

The staff expects that participating contracts that qualify for the use of the variable fee approach would not use a fully retrospective transition approach because, unless the entity had previously recorded the fair value of underlying items at the end of each reporting period, retrospective application would be impracticable. The simplified retrospective approach would also not be easily applicable under a variable fee approach since the CSM is estimated under that model at the start of the earliest period presented as if all changes in estimates before that date were known at initial recognition (including changes in an entity's share of underlying items). Determining this would not be possible without the use of hindsight.

Therefore, the staff proposed further specific simplifications to the simplified retrospective approach for participating contracts. These simplifications relate to the estimation of the CSM at initial recognition. The CSM is to be calculated as:

- ▶ The expected variable fee at the transition date (the fair value of the entity's share in the returns from underlying items plus/minus the costs of providing the contract at that date), discounted back to the date of initial recognition

Less

- ▶ The actual payments of variable fees made to shareholders from initial recognition to the transition date.

The staff also proposes a simplification to determining the amount reported in accumulated OCI when the current period book yield approach is applied. Under this approach, the interest expense in profit or loss is equal and opposite in amount to the investment income on the underlying items reported in profit or loss for the period. Any difference between the interest expense reported in profit or loss and the interest determined on a current market basis on the liability would be reported in OCI. Similarly, the staff proposes that at transition date, the accumulated OCI amount on the insurance liability is set equal and opposite to the accumulated OCI amount on underlying assets at that date.

One Board member suggested that a fair value approach would provide more comparability and that the logical extension of this could be to use fair value, not just for transition of participating contracts, but as a single transition objective for all types of contracts. However, the IASB Chair had no plans to revisit previous decisions in this area. The staff noted that other standards have not enforced a single path for retrospective application, and they are not looking to enforce one option. One Board member issued an open request to the global industry to educate the Board on the transition model proposed by the Board, on the basis that it may be the most complicated area of the standard to apply.

Participating contracts that do not qualify for the variable fee approach

On the proposed accounting for participating contracts that do not qualify for the variable fee approach (indirect participation contracts), staff referred to previous tentative decisions on measurement relating to the general building block approach that would apply to these contracts.

The application of the general building block model to indirect participating contracts would result in a different accounting than for contracts qualifying for variable fee approach because:

- 1) The adjustment to CSM for changes in future cash flows under the contract would be determined using locked-in historic interest rates as opposed to a current rate under the variable fee approach
- 2) The rate used to accrete interest on the CSM would be locked-in as opposed to a current rate under the variable fee approach
- 3) The remaining balance of the CSM would not be remeasured to reflect the impact of changes in financial inputs from the date of inception on the value of the CSM using current interest rates, while this would implicitly happen for contracts under the variable fee approach



The staff explained how changes in the variable fee amounts that are subject to discretion should be accounted for under the general building block model:

- ▶ If there is a change in market interest rates, but no change in the participation rate, the change in the expected fulfilment cash flows is recognised in either profit or loss or OCI as a change in a financial input that does not affect future services
- ▶ If there is a change in the participation rate, but no change in market interest rates, the change in the expected fulfilment cash flows is adjusted in CSM as a change relating to expected future services.

The Board asked for further clarity on the application of discretion: whether this is a variation in pay-out, a change in percentage of participation, or a change in the present value of a spread of earnings.

Many Board members noted that if the accounting for participating contracts that qualify for the variable fee approach was significantly different to that applying to contracts that do not qualify, this needed to reflect real economic differences. If this was not the case, then, perhaps, previous tentative decisions on the building block model would need to be revisited - either for all contracts or just for participating contracts. Board members expressed differing perspectives on whether the decision to accrete interest on the CSM at the locked-in rate for non-participating contracts should be revisited.

Staff also revisited discussions on the effective yield approach to determine interest expense when a participating contract does not qualify for the current period book yield approach. During a previous meeting, the staff presented a 'level' effective yield method as their preferred way to implement an effective yield approach. Under the level effective yield approach, the interest expense in the profit or loss is determined using a single discount rate that reverses amounts recognised in OCI over the life of the contract. Any difference between the interest expense reported in profit or loss and the interest determined on a current basis on the liability would be reported in OCI. At that previous meeting, Board members asked staff to consider modifications to a level effective yield approach to minimise accounting mismatches. However, the staff now proposes not to make any further modifications to this method because the current period book yield method is now expected to cover situations where the insurer holds the underlying assets. One Board member commented he finds the numbers in the example with the level effective yield difficult to comprehend and explain. The staff acknowledged the level effective yield method is somewhat crude but believes this is justified by the avoidance of the additional complexities of any modifications to the effective yield approach.

Several Board members saw the scoping of the application of the variable fee approach and that described above for indirect participating contracts as one of the most important issues to resolve.

Accounting policy choices for presentation of the impact of discount rates for participating contracts

The staff identified three possible approaches to the presentation in profit or loss of the impact of changes to discount rates on insurance contract liabilities:

- ▶ The current updated market discount rate with no amount being recognised in OCI
- ▶ The current period book yield approach
- ▶ The level effective yield approach

For non-participating contracts, entities will have a choice of two options either to present interest expense in profit or loss or OCI. Staff proposed that both choices should be extended to participating contracts.

Participating contracts where the variable fee approach would not apply, the choice would be limited to those choices and to either recognise all interest expense in profit or loss using current market discount rates or to recognise it in profit or loss using the effective yield approach.

However, for contracts where the variable fee approach applies, a third choice would be available. A company may also elect to use the current period book yield approach (provided the entity actually holds the underlying assets identified under the contract). Staff proposed that, in these cases, the entity should have a three-way choice of policy to present interest expense in profit or loss using either: the current period book yield approach, the effective yield approach or using current discount rates. A few Board members queried whether it would be necessary for entities to be able to select the effective yield approach for contracts that are in scope of the current period book yield approach. The staff clarified that some entities may choose the effective yield approach if they envisaged that the portfolio may cease to qualify for the variable fee approach, because they may no longer hold the



underlying items, or if the obligation no longer equals the value of underlying items less a variable fee for service.

Several Board members raised concerns about introducing too many options and the impact on users of financial statements. Some members indicated a preference for a high hurdle for allowing choices only when essential. Therefore, they suggested that if participating contracts qualify for the current period book yield approach they should choose either that approach or the current market interest rate approach, rather than have a three-way choice.

Board members also discussed whether, in order to reduce complexity, there should be greater consistency of accounting for direct and indirect participating contracts. This would avoid significant differences in accounting between two economically similar contracts falling on either side of the dividing line between those contracts

qualifying for the current period book yield approach and those using the effective yield approach.

One Board member replied to a staff enquiry that it was impossible to say whether the Board wanted to avoid cliff effects by removing options such as the current period book yield approach; or whether it was inclined to allow such options in order to get the right accounting treatment. The staff noted that it is a question the Board will have to vote on soon.

IFRS 9 Financial Instruments

The staff provided a brief update on the interaction between IFRS 9 and the insurance contracts standard. It was noted that the European Financial Reporting Advisory Group (EFRAG) had advised the European Commission to ask the IASB to defer the effective date of IFRS 9 for insurance businesses and to align it

with the effective date of the new insurance contracts standard. However, the EFRAG emphasised that IFRS 9 should be endorsed for use in Europe, and should be applicable without delay to entities other than insurers.

Board members commented that, while there had been a lot of discussion on assets and potential volatility related to the implementation of IFRS 9, before IFRS 4 Phase II was in force, the impact that changes in asset values may have on liabilities also needs to be considered (e.g., for participating contracts, and incorporating the use of shadow accounting). The Board will continue to monitor developments and wait for further detail on the potential effects on both sides of the balance sheet to get a clearer picture of the size and nature of issues arising from implementing IFRS 9 before IFRS 4 Phase II.

How we see it

During the May discussions, Board members noted that the approach to the CSM in the general building block model will be very different to that in the variable fee approach. Essentially, the CSM is a historical amount under the general building block model, while it is on a 'current' basis in the variable fee approach. This has an impact on the relative amounts recognised as underwriting income and interest expense.

The greater the difference between the accounting outcomes of the variable fee approach and the general building block model, the greater the concern that economically similar contracts are accounted for very differently, depending on whether or not they meet the requirements to use the variable fee approach.

The IASB needs to decide whether to revise decisions made about the CSM in the general building block model, based on the decisions for participating contracts - and whether to do this only for participating contracts or for all. Will the added complexity be worth it? Or will a more generally applicable approach be better, even if that leaves little room to reflect on the features of specific contract types?

The discussions on IFRS 9 may be seen as implying that the IASB is at least open to discussing a delay to the mandatory adoption date of IFRS 9 for insurers. Of course, this will come with complications around how to define those entities that are allowed to delay, and how to deal with accounting by financial conglomerates.

The May education session has moved the discussions on participating contracts forward, but difficult technical decisions remain to be made. In his closing remarks, the Chair stated that the staff should advance to final papers for decision, which reflects a determination to complete the project expeditiously.

What's next?

While the Board essentially completed the development of the model for non-participating contracts during previous meetings, its model for insurance contracts with participating features has yet to be finalised.

The Board's next meeting on insurance contracts is expected to be in June. The topics have not yet been announced, but will likely cover redeliberations on contracts with participating features following the recent education sessions. Once the discussions have been completed, and deliberations concluded, the IASB will consider the mandatory effective date of the new standard. The IASB expects the new standard to be published in the course of 2016.

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