IASB continues its discussions on participating contracts

Overview
During the March 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 'general model' applied to non-participating contracts for contracts with participation features (participating contracts). In particular, the following three issues were addressed:

- How to view an entity’s economic interest in the underlying items referenced by those contracts and, on that basis, whether to adjust the Contractual Service Margin (CSM) for changes in the value of these underlying items
- How to determine the interest expense in profit or loss for participating contracts
- How to release the CSM on participating contracts to profit or loss over time

No decisions were made.

The story so far
The IASB’s website provides information about tentative decisions made on the insurance contracts accounting model prior to this meeting, including:

- The cover note for the insurance contracts papers for the March meeting which contains a summary of progress so far1
- Further information on the project and the proposed model2

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1 http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/March/AP02-Insurance%20Contracts.pdf
An entity's economic interest in underlying items

Participating contracts provide policyholders with benefits that vary with returns on underlying items, in addition to any guaranteed benefits. The staff proposed two possible views on the entity's interest in such underlying items:

- As a share of economic returns from the items
- Or
- As a variable fee for service

The staff explained that the first view would be in line with the approach already outlined in the 'general model' for non-participating contracts. This view would not require any adjustment to the building block model to defer the impact of changes in underlying items against the CSM. This is because changes in the entity's share of underlying items would be reported in accordance with the accounting model used for the underlying items themselves (e.g., in accordance with IFRS 9 Financial Instruments). The share of the value of those assets that are allocated to policyholders would be reflected as increases to the fulfilment value.

Under the second view, 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 charged 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. Changes in the value of underlying items would be adjusted against the CSM to reflect the change in the expected variable fee for services (i.e., unlocking of the CSM). The variable fee would be reported in profit or loss over time as part of the underwriting result through the release of the CSM. The staff emphasised that the variable fee only relates to the return on specified underlying items. To the extent an entity chooses to invest in alternative assets, any difference compared with the return on the underlying items would be an investment return based on the entity's actual investment strategy.

The Board devoted most of the time discussing the second approach and when this would apply. The Board understood the staff's explanation of, and the arguments for and against, each of the two views. Some Board members expressed sympathy towards the second (variable fee) view and noted the analysis in the staff paper offers a significant step towards resolving the issues around the CSM 'unlocking' for changes in the entity's share in the value of the underlying items.

The staff noted that, under the variable fee approach, any guaranteed investment returns to policyholders would be an integral part of the entity's variable fee and the CSM would be adjusted for changes in the value of guarantees accordingly. The staff believes this is not inconsistent with a performance guarantee accounted for under IFRS 15 Revenue from Contracts with Customers, where variations in cost would lead to a reduction in margin until the contract becomes onerous. Some Board members queried whether the effect of guarantees for minimum returns should be separated out, rather than included in the variable fee. The staff replied that the proposal does not separate out guarantees on both practical and conceptual grounds. Practically, any easily separable elements of a contract would already have been separated. Conceptually, it would be logical to keep the effect of changes in value of guarantees in the CSM, since expected future cash flows under the contract include the estimated effect of guarantees.

Particular concerns were raised by several Board members on the counter-intuitive result that entities trying to mitigate against the risk of minimum return guarantees may end up with more volatile results than those entities that do not. If derivatives or asset portfolios are held to mitigate these risks, changes in these assets may have to be reported in profit or loss, whereas the corresponding changes in the value of the guarantees are reported in the CSM. Whilst these Board members strongly believed that such an outcome would be unwarranted and should be resolved, they also made it clear that any solution should be clearly defined and built on robust criteria. One Board member observed that, under the alternative proposals presented by several industry groups, the proposed recognition of changes in the value of guarantees would be in either CSM or Other Comprehensive Income (OCI).
Criteria for applying the variable fee approach

The staff outlined possible criteria for participating contracts to qualify for the variable fee approach, if the Board were to adopt this approach:

- The contract specifies a participation in clearly identifiable underlying pools of assets (or other underlying items)
- The entity expects that a substantial proportion of the cash flow from the contract will vary with underlying items
- The entity expects that the policyholder will receive a substantial share of the returns

The staff added these criteria would result in a narrower scope than the alternative proposal set out by industry groups, which would include all contracts that pay benefits that vary with returns on underlying items.

Board members noted that consideration of how to scope in or out contracts was as important as whether or not to accept the variable fee approach. They requested further education on what is meant by ‘substantial’, and on the implications of leaving scoping to judgement versus providing more prescriptive gating criteria.

A board member also asked what percentage of current participating contracts would tend to fall in and outside the scope. The staff expects that most index-linked, unit-linked, and European ‘90/10’ with-profits contracts will be in scope. The staff added that contracts commonly referred to as universal life contracts, if not based on a clearly identifiable pool of assets, would not fall into scope, and may require a model based on the general accounting approach with specific modifications.

Issues relating to mutualisation across generational cover and the level of aggregation were deferred to a future session.

Measurement of contracts and interest expense

The staff also discussed the measurement of participating contracts, considering both the treatment under: (a) the approach whereby the underlying items provide a share in economic returns from these items; and (b) the variable fee approach. The staff explained that under the former approach, the treatment of the entity’s shareholder share would follow the general model for non-participating contracts. Under the latter approach, the general model would be adapted to reflect the ‘unlocking’ of the CSM for the variable fee from the entity’s share in the underlying items.

The use of current or locked-in discount rates to determine the present value of adjustments to the CSM and the accretion of interest to the CSM were discussed briefly. Where a variable fee approach is adopted, adjustments in the CSM will reflect the current period estimate of the asset return, so discount rates used for measurement should be current rates.

Interest expense in the statement of comprehensive income

The staff proposed that the following approaches should be used if the Board decides to permit or require an OCI approach for contracts with cash flows that vary with returns on underlying items:

- Current period book yield approach
- Effective yield approach

The current period book yield approach envisaged by the staff would apply:

- To contracts that would be in scope of a variable fee approach, and
- Where the underlying items are held by the entity to ensure an exact match between the items underlying the obligation and the obligation itself exists

The staff clarified that, under this current period book yield approach, the interest expense in profit or loss on the insurance contract liability would be equal and opposite to investment income on the underlying items. The difference between the interest expense in profit or loss and the interest expense determined based on current rates would be reported in OCI for both the underlying items and the insurance liability. The staff added that the exact mechanics of this method differ somewhat from the current portfolio book yield approach discussed by the Board at a previous meeting. The current period book yield approach would also be more restricted in scope as it only applies when there is no possibility of an economic mismatch; it applies when the conditions for applying the variable fee approach are met and the entity holds the underlying items.

The staff proposed the effective yield approach for determining interest expense where variable returns are a substantial proportion of total benefit to policyholder, but the contract does not meet the conditions for the variable fee approach. The effective yield approach updates locked-in discount rates to reflect changes in underlying items for all cash flows in the contract. Rates are ‘reset’ when a change in estimates of returns results in a change in expected amounts credited to policyholders. The difference between the interest expense recognised in profit or loss on the basis of the effective yield and the interest expense used for measurement (current rates) would be recognised in OCI for the insurance liability. The Board will further discuss the specific mechanics of an effective yield approach at a future meeting.

The Board reacted sympathetically to the interest expense approaches outlined by the staff, and considers the explanation of current period book yield approach to be a significant improvement to previous explanations. One board member asked if ‘interest expense’ would be better renamed as ‘investment expense’ or ‘change in liability’ because the amount of the variable return credited to policyholders could be negative in some reporting periods.
Some Board members suggested that the Board revisit its previous tentative decision to accrete interest on the CSM for non-participating contracts at an interest rate determined at inception.

Reassessment of eligibility

The Board did not make any specific comments regarding the staff proposal on reassessment of accounting approaches for participating contracts. The staff explained that, generally, there would be no need to reassess eligibility after inception, analogous to the approach taken to determine significant insurance risk and the eligibility for the Premium Allocation Approach. The staff clarified reassessment would only be relevant with respect to the current period book yield approach; if an entity would no longer choose to hold the underlying items, the rationale for using the current book yield approach would no longer exist. If the entity no longer holds the underlying items for a contract, it would cease to apply the current book yield approach to this contract and apply the effective yield approach instead.

Recognition of the CSM in profit or loss

The staff then discussed how to recognise the CSM in profit or loss for participating contracts. In these contracts, investment-related services are provided to policyholders in addition to the provision of insurance coverage. Therefore, possible bases for recognising the CSM could be the passage of time and assets under management.

The staff proposed that the passage of time is the least arbitrary and cleanest way to release the CSM for participating contracts. Any distinct components of the contract providing different patterns of service over time will already have been separated. Also, if a predominant service is chosen as a driver, this could change over the life of the contract (e.g., guaranteed annuity options have more asset management services in the accumulation phase, prior to exercising the option, after which point, insurance coverage is the predominant service). This could cause difficulties and complexities if there were a need to reassess each period.

The Board debated the staff proposal and raised concerns that simply using the passage of time as a basis could overstate fees received in early years and understate those in later years. Some Board members expressed some hesitation about this release method despite its inherent logic, having already decided not to include the constraints on variable consideration from IFRS 15 in the accounting model for insurance contracts. For example, in contracts with regular premiums and an incremental explicit fee deducted each year, CSM release could exceed the fee received in early years.

One Board member commented that, in his view, both the characteristics and the quantum of assets under management could be driving factors in the provision of services (e.g., investments that are more complex and diversified in nature, requiring greater investment management services than, for example, government bonds).

However, this Board member also acknowledged the considerable complexities of incorporating such elements into the release pattern of the CSM. Another Board member indicated a preference for the predominant service approach to recognising the CSM in profit or loss, with entities estimating service in early years relative to total service and applying this release factor to the CSM. However, the staff pointed out that it would be difficult and arbitrary to tell exactly how the relative service amounts change over time.

A number of Board members added they are keen to avoid too much complexity.

How we see it

Discussing a comprehensive model for participating contracts is challenging due to the range of issues that need to be resolved simultaneously. The Board has previously received input from various industry groups on the accounting for participating contracts. If the Board decides to adopt the unlocking of the CSM for the entity’s share in the underlying items, as discussed at this meeting, this would bring the Board’s approach and the industry proposals substantially closer.

Nevertheless, some important matters remain to be resolved. Chief amongst these are: the level of aggregation; the avoidance of accounting mismatches for entities that protect economic exposures arising from the contracts through the use of derivatives; and the allocation of the CSM in a way that balances the need to faithfully represent the transfer of services of insurance contracts with the understandability of the results.

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3 The rationale is: elimination of an accounting mismatch between interest expense on liabilities and investment income on assets where no economic mismatch exists.
What’s next?

While the Board has essentially completed the development of the model for non-participating contracts at previous meetings, issues relating to its model for insurance contracts with participating features have yet to be resolved.

The March meeting moved the discussions forward, but further deliberations on contracts with participation features are likely to continue over the coming months. The Board’s next meeting on insurance contracts will be in April. The topics have not yet been announced, but will likely cover redeliberations on contracts with participation features, with further discussion on topics such as the level of aggregation and mutualisation between generations. Once these discussions have been completed, the IASB will consider the mandatory effective date of the new standard. The IASB does not expect the new standard to be issued before the end of 2015.
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