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Notes from the IASB education session held on 19 March 2015

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Insurance contracts

The IASB held an education session on 19 March 2015 to discuss adaptations for insurance contracts that provide policyholders with benefits that are dependent from returns generated by underlying items (such as investment returns from financial assets) that the insurer holds to back those insurance liabilities ("participating contracts").

Background and scope (agenda paper 2A)

The insurer's interests in underlying items can be viewed either as a share in the economic returns from underlying items (which would not result in the need to adapt the IASB's general model), or as a variable fee for service (which would result in the need to adapt this model).

Viewed as a share in the economic returns from underlying items
Under this view the insurer has legal title of the investment portfolio and an obligation to pay policyholders amounts based on the underlying items. The insurer controls the cash flows, and its primary aim is to increase its share of those cash flows, even when it is required to act in a fiduciary capacity for the policyholder. The policyholder is entitled to a portion of the returns, with the remaining returns due to the insurer, therefore depicting gains and losses on the insurer's share of the underlying items in the same way as a standalone investment would be appropriate. Consequently, only the net gains and losses that the insurer passes to the policyholder would be recognised as changes in the insurance liability, which would have an offsetting effect against gains and losses recognised on the insurer's investment portfolio.

The investment margin in the insurer's profit or loss would be reported as the difference between the gains and losses on the insurer's investment portfolio and the interest expense on the insurance liability.

Viewed as a variable fee for service
An alternative view is that any benefit the insurer receives from its share of underlying items is only as a consequence of holding those items on behalf of policyholders. It is therefore inappropriate for the insurer to report the gains and losses on its share of those underlying items as if it partly owned them. The insurer is often constrained because the quantum of the underlying items is determined from premiums paid by policyholders, it is usually expected to manage the invested premiums for the benefit of the policyholder, it must follow the investment strategy specified in the contract, and it is required to act in a fiduciary capacity. Thus, the policyholder receives all the variable returns from the underlying items and pays the insurer a variable fee out of the proceeds of its investment.

The financial statements would report a net investment margin only to the extent that the return on the assets the insurer holds does not match the return on the promised underlying items. This would be achieved if the insurer's obligation to the policyholder was considered to be the net of (a) the obligation to pay an amount equal to the value of the underlying items and (b) the fee that the insurer expects to receive for its services. At inception, the variable fee for future services would comprise the insurer's share of the returns on underlying items less the expected outflows that relate to any non-investment cash flows or guarantees. Consequently, changes in the fair value of options or guarantees in the contract would be adjusted against the CSM.

Obligation to pay the policyholder the value of the underlying items less a variable fee

Where in certain circumstances the insurer's obligation is to pay the policyholder the value of the underlying items less a variable fee for services, the scope of this approach would need to be specified as it would have a different accounting outcome compared to the general approach for non-participating insurance contracts. Under this approach the insurer would offset in the CSM the effect of its own exposure to variable underlying items, whereas under the general approach the CSM is not adjusted for the effect of changes in the insurer's exposure to assets that the insurer holds.

In the Staff's view an approach that reflects the insurer's obligation to pay the policyholder the value of the underlying items less a variable fee would be valid only when:

- The contract specifies that the policyholder participates in a clearly identified pool of underlying items;
- The insurer expects that a substantial proportion of the cash flows from the contract will vary with changes in underlying items; and
- The insurer expects the policyholder to receive an amount representing a substantial share of the returns from underlying items.

The Staff's proposal for adaptations for participating contracts has a narrower scope than the CFO Forum's proposal, and would exclude, for example, contracts for which the obligation is not based on a clearly identified pool of underlying items.

An IASB member questioned why the cost of guarantees would be included within the cash flows used for the measurement of the variable fee. The Staff stated that guarantees would be difficult to separate, and are inter-related with these variable investment management fees, because if the value of investments increases the cost of guarantees falls and in both instances the amount the insurer earns is affected. This IASB member stated that at least one insurer believes that changes in the measurement of options and guarantees should be presented in profit or loss. The Staff added that some insurers separately measure options and guarantees, and some insurers believe that changes in their measurement should be presented in OCI.

An IASB member noted that there are different generations of policyholders therefore it would be difficult to establish whether a policyholder participates in a clearly identified pool of underlying items. He also asked what was meant by a 'substantial' proportion of cash flows from the contract that will vary with changes in underlying items, and whether some criteria would be provided on how this should be interpreted. The Staff noted that the contract should indicate the underlying items (which may not be restricted to assets) and hence what obligations have arisen. The Staff proposed that the insurer should judge what is 'substantial' rather than the IASB setting an arbitrary bright line. Another IASB member questioned what the downside would be of not having criteria, as these made it more difficult to qualify for the variable fee approach, and stated that guidance on the interpretation of ‘substantial’ would be helpful.

A few IASB members commented that the proposal would result in volatility for insurers that are hedging their risks on the variable fee. They suggested that a solution is required to ensure only economic mismatches are recognised in profit or loss or to delineate circumstances when the variable fee approach should not be applied.

An IASB member considered that criteria were required to determine in what circumstances an insurer would be considered to have a policyholder obligation so that it would be possible to distinguish between contractual, customary or economic compulsion. The Staff noted that an expected loss basis was specified in the 2013 ED.

Another IASB member asked the Staff the extent to which insurance contracts would qualify for the variable fee approach. The Staff considered that most Universal Life contracts (Deloitte believes that these contracts would be more common in North America than in other markets) would not qualify, therefore the effective yield approach without the adjustment to the CSM would have to be applied. The Staff also observed that variable annuity contracts, unit-linked contracts and participating contracts commonly found in all European markets (e.g. UK With-Profit contracts) would likely be in the scope of the revised measurement model.

Proposed accounting for CSM and OCI (agenda paper 2B)

Measurement

The Staff considered that when an insurer’s obligation *can* be viewed as an obligation to pay the policyholder an amount equal to the value of the underlying items less a variable fee for service:

- No adaptations are needed to the general approach for the fulfilment cash flows or the CSM at initial recognition that is currently approved for use for non-participating contracts;
- The CSM after initial recognition would be adjusted for changes in the expected net variable fee for the services under the contract and for changes in the expected present value of the cost of guarantees; and
- Current rates would be used to determine the present value of adjustments to the CSM and to accrete interest on the CSM.

The Staff considered that when the insurer’s obligation *cannot* be viewed as the obligation to pay an amount equal to the value of the underlying items less a variable fee for service:

- No adaptations are needed to the general approach for the fulfilment cash flows, the CSM at initial recognition or the CSM after initial recognition; and
- Locked-in rates are used to determine the present value of adjustments to the CSM and to accrete interest on the CSM.

The Staff acknowledged that some preparers have suggested that current rates could also be used for non-participating contracts when the CSM adjustments and the accretion are accounted for. This request will be considered when the IASB will revisit non-participating contracts accounting against the decision on the participating contracts model.

Interest expense in the statement of comprehensive income
The IASB has yet to consider whether to permit or require the OCI approach for participating contracts, using the effective yield or the current period book yield for determining interest expense in profit or loss. If the IASB decides to adopt an effective yield approach, the Staff would consider whether a level yield or a crediting variation of this approach should be used.

The Staff proposed that if the current period book yield approach is used, an insurer should determine the interest expense in profit or loss on the insurance contract liability as equal and opposite in amount to the investment income on the underlying items that is reported in profit or loss. Any difference between this interest expense and the interest expense determined on a current basis would be reported in OCI.

The Staff believes that the current period book yield approach should apply only when:

- There is a match between the insurer's obligation to the policyholder and items that the insurer holds; and
- An insurer's obligation is to pay the policyholder an amount equal to the value of the underlying items less the variable fee for service, and the insurer holds the underlying items, either though choice or because it is required to.

Reassessment of eligibility for accounting approaches
The Staff proposed that there would be no requirement for an insurer to reassess whether a substantial proportion of cash flows from the contract vary with changes in underlying items after initial recognition.

However, the Staff thinks that there should be a reassessment of whether an insurer holds the underlying items for the purpose of applying a current period book yield approach, because if it does not hold such items there would be an economic mismatch. In such circumstances the Staff believes that an insurer should be required to discontinue the current book yield approach and instead apply the effective yield approach.

An IASB member commented that 'interest expense' was not always like interest and was not always an expense, and the Staff agreed to identify a more suitable term. The Staff stated that is intends to produce a paper that sets out the accounting for both the current book yield approach and the effective yield approach.

Recognition of CSM in profit or loss (agenda paper 2C)

The paper considered approaches to take the CSM to profit or loss after initial recognition.

The investment-related service that characterises participating contracts could be considered to be governed by a combination of the passage of time and the amount of assets under management. The Staff argued that this service is not related to the timing of when returns are distributed or assigned to policyholders, or the pattern of expected investment returns.

The Staff reminded the IASB that the 2013 ED requires an insurer to unbundle distinct services while those services that are highly interrelated and integrated with each other will remain bundled.

Against this background the paper argued that it would not be practical to further separate such bundled services, other than on an arbitrary basis, therefore they believe that an insurer should select a single driver to allocate the CSM to profit or loss over the coverage offered in the contract. As it can be difficult to assess the predominant service of an insurance participating contract, the Staff believes that the least complex and subjective approach would be to require an insurer to recognise the CSM on the basis of the passage of time.

An IASB member asked if the passage of time would be on a straight-line basis, which was confirmed by the Staff. This IASB member expressed the view that as the IASB had developed concepts for the recognition of the delivery of other services within IFRS 15 those concepts should also be applied to the CSM when relevant. The Staff commented that present values effectively measure cash flows as if they all occurred at the same time, and the risk adjustment reflected the release from risk.

An IASB member questioned whether assets under management was too important not to be taken into account as the values would be known, and he felt that recognising the CSM on the basis of the passage of time was too simple. The Staff responded that even if two drivers were selected, these can change over time. Another IASB member noted that with the passage of time approach more profit would be recognised early in the contract term than would be the case under IFRS 15 *Revenue from Contracts with Customers* and questioned why the amount of service provided could not be determined each year. He accepted that the proposed approach would lead to greater comparability between insurers, but leaned towards a predominant service approach. The Staff agreed that it would be possible to reassess the predominant service each year.

Next steps

The tentative decisions to be taken by the IASB on participating contracts may result in the need to reconsider the tentative decisions taken on non-participating contracts.

The expected publication of the new IFRS for insurance contracts is now likely to be right after the end of 2015. The IASB will consider a system to facilitate testing and implementation of the new IFRS. Deloitte believes that this system could result in the creation of a Transition Resource Group for Insurance Contracts similarly to those created for Revenue Recognition and for Impairment of Financial Instruments.
