# Contracts with Participation Features

## First set of decisions after extensive preparation and outreach activities

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# Agenda

- Highlights of the latest IASB discussions
- Detailed analysis of the IASB discussion at the meetings held on 23 and 25 June 2015 with selected references to prior education sessions
- Next steps and update on timetable

# Highlights

**Three fundamental decisions have been voted with different levels of support. The new accounting approach presents significant similarities with the industry and Deloitte proposals for participating contracts**

- Variable fee approach for direct participation contracts is approved as a modification of the general measurement model. The CSM unlocking for these contracts will include also the insurer's share of the underlying items
- Recognition of CSM in profit or loss for contracts with participation features will follow the same model as non-participating contracts and be based on the passage of time on a contract by contract basis

**Education session on 23 June focussed on IFRS 9 deferral for insurers**

- Hedging of risks related to insurance activities with a focus on derivatives that are not part of the underlying items
- Application of IFRS 9 before the new insurance contracts Standard and the merit to defer IFRS 9 for insurers
- Use of IFRS 4 to address the consequences of applying IFRS 9 before the new insurance contracts Standard
- Complexity of deferring the effective date of IFRS 9 for the insurance industry

# Variable fee approach for direct participation contracts

Modification of the general model when an insurance contract creates an obligation to pay an amount equal to specified underlying items, less a variable fee for service

**The conceptual basis that the IASB considered is that the returns to the entity arising from a participating contract and the associated investments are viewed as part of the compensation charged for the service provided**

- Changes in the estimate of the share of returns should be regarded as a change in the entity's compensation
- This income should be recognised in the periods in which the service is provided
- Any benefits received by the entity would thus arise only as a consequence of it holding those items on behalf of the policyholder
- This conclusion is confirmed by the fact that the entity is often constrained from exercising control over these investments
- Consequently the entity's interest in the investment portfolio should be regarded as a variable fee that it charges to the policyholder
- The alternative concept of an insurer's interest in the underlying items has been abandoned in the IASB standard setting work in favour of the variable fee approach

# Variable fee approach for direct participation contracts

## Staff recommendations

1. For contracts with direct participation features, the IASB should modify its general measurement model so that changes in the estimate of the fee the entity expects to earn from the contract are adjusted in the CSM. That fee is the entity's expected share of the returns on underlying items less any expected cash flows that do not vary directly with the underlying items.

2. Contracts with direct participation features should be defined as contracts for which the contractual terms specify that
   1. the policyholder participates in a defined share of a clearly identified pool of underlying items;
   2. the entity expects to pay to the policyholder an amount equal to a substantial share of the returns from the underlying items; and
   3. a substantial proportion of the cash flows that the entity expects to pay to the policyholder should be expected to vary with the cash flows from the underlying items.

# Variable fee approach for direct participation contracts

## IASB discussion and tentative decision – Recommendation 1

### Recommendation 1 – IASB discussion

- General support for the variable fee approach – fourteen months of education and outreach appear to have paid off
- Re-measuring a guarantee would affect the measurement of the variable fee and hence the amount recorded in the CSM. This feature is not new and it is consistent with the general measurement model
- A contract with participating features could be viewed as essentially a risk-sharing arrangement, it is inappropriate to draw parallels with revenue recognition
- Concerns about the weakening of the importance of the profit & loss account because of the extensive use of the CSM and OCI, therefore necessary for disclosures to see the overall position
- The consequence of applying the variable fee approach is that derivatives will need to be considered vis-à-vis their inclusion in the underlying items or not

### Tentative decision

- Thirteen IASB members voted in favour of Staff recommendation 1, with one member against

# Variable fee approach for direct participation contracts

## IASB discussion and tentative decision – Recommendation 2

**Recommendation 2 – IASB discussion**

- The approach is quite rules-based
- The objectives, criteria and guidance would be helpful
- Differing views emerged during the debate on whether the variable fee approach should be regarded as a practical expedient to be applied to the general model, as it reflected the particular features of the participating contract
- Scoping and reassessment of whether the definition of a direct participating contract applies to different types of contracts with asset dependent cash flows is important in order to achieve the same accounting treatment for economically similar contracts
- However, the Staff considered that reassessment should not be required
- During the May 2015 education the definition of an indirect participating contract was discussed. These contracts would not be under the variable fee approach

**Tentative decision**

- Nine IASB members voted in favour of Staff recommendation 2, with five members against

# Variable fee approach for direct participation contracts

## A simple illustration using Deloitte 2013 proposal

**Extracted from Deloitte 2013 response to the IASB ED Insurance Contracts**

- Assume a single premium participating contract with Currency Units (CU) 100 premium received on initial recognition which requires the insurer to invest in an underlying internally held fund.
- The returns of the fund are retained within it and distributed to contract holders on the basis of a 90 per cent share of any amount that the insurer discretionarily declares available for distribution out of the accumulated returns.
- The insurer offers the contract holders a minimum guarantee return of 1% on top of the premium paid
- At initial recognition the fulfilment cash flows value is CU92 and the CSM is CU8
- In the subsequent period the underlying items generate CU10 positive returns. The fulfilment cash flows amount would increase by CU9 expected to be declared as dividends in the future.
- The insurer would unlock the CSM by adding the change of underlying items of CU10 and subtracting CU9 from the opening balance. The CSM closing balance is now CU9. This is before application of any CSM release for services rendered.

# Recognition of CSM in profit or loss for contracts with participation features

## Pattern of delivery of investment-related services and Staff recommendation

- When an insurance contract creates an obligation to pay the policyholder an amount equal to the value of the underlying items, less a variable fee for service, the contract provides both investment-related services and insurance coverage
- Conversely, where an insurance contract does not create that obligation, the entity arguably undertakes all investment-related activity for its own account and provides a discretionary return to the policyholder
- Contracts with participation features could be viewed as providing investment-related services in addition to insurance coverage
- The CSM should be recognised in profit or loss in a systematic way to reflect the transfer of services provided, therefore the pattern of delivery of the investment-related services, and how the CSM should be recognised when there is more than one type of service provided needs to be considered

**Staff recommendation**

- For contracts with participation feature an entity should recognise the CSM in profit or loss on the basis of the passage of time

# Recognition of CSM in profit or loss for contracts with participation features

## IASB discussion and tentative decision

- The mix of services provided by an insurance contract can vary from period to period, but this would be difficult to measure
- Some support for recognising the CSM in profit or loss taking into account the different pattern of services provided, or applying the passage of time unless the entity can demonstrate that another method would more faithfully represent the provision of services in each reporting period
- Ideally each performance obligation should be measured as proposed in the 2013 ED, but the feedback was that there is no consistent way of measuring these obligations therefore more guidance would be required

**Tentative decision**

- Twelve IASB members voted in favour of the Staff recommendation, with two members against

# Hedging of risks related to insurance activities

## Accounting mismatches arising from using a derivative

- If the general model is modified, changes in the estimate of the variable fee would be adjusted in the CSM (variable fee approach), when applicable
- The CSM would be adjusted by the effect of changes in financial market variables, but if such risks are hedged using a derivative, an accounting mismatch would arise because changes in the value of the derivative would be recognised in profit or loss
- Three approaches have been identified that address these mismatches:
  - Limited application of the variable fee approach
  - Recognition of changes in the value of guarantees and the entity's share of underlying items in profit or loss instead of the CSM
  - Designation of the derivative as an underlying item
- These approaches could be applied unconditionally, or conditional on specified criteria

# Hedging of risks related to insurance activities

## IASB discussion

- Several IASB members expressed a preference for approach 3
- Most consistent with variable fee approach
- No support for hedge accounting under IFRS 9
- The biggest problem with the variable fee approach arises where there are guarantees and the entity shares in the underlying items.
- Derivatives can be purchased for the entity’s share in the underlying items to be hedged against the negative impact of those cash flows that are not directly related to the underlying items.
- A typical example would be a minimum guaranteed interest rate. Interest rate swaps could be entered to hedge its impact on the future share of underlying items that the entity expects to receive.

# Application of IFRS 9 before new insurance contracts Standard

## Issues that could arise

- EFRAG issued a DEA  stating that applying IFRS 9 before the new insurance IFRS may be disruptive, make financial reporting less understandable and increase costs for insurers and investors

- Proposed that the EC asks for a deferred effective date of IFRS 9 for insurance businesses

- Some parties think that IFRS 9 should be applied without delay, and any temporary measures to address concerns should be optional

- Temporary increase in accounting mismatches resulting from changing the classification of financial assets without changing accounting for insurance liabilities, two sets of accounting changes in a short period, more cost and effort

# Application of IFRS 9 before new insurance contracts Standard

## Issues that could arise (cont.)

- Delaying the application of IFRS 9 could diminish the relevance of financial statements, even if this results in temporary increases in accounting mismatches
- This issue could be addressed by existing or new accounting policy options under IFRS 4
- Effective date of IFRS 9 could be deferred for entities issuing insurance contracts
- A deferral could create added costs and complexities, reduced comparability in accounting for financial instruments and a risk of earnings management
- Would involve the application of deferral guidance followed by the application of IFRS 9 with the new insurance contracts Standard

# Application of IFRS 9 before new insurance contracts Standard

## IASB discussion

- May be operationally easier to apply IFRS 9 before the new insurance contracts Standard because of the limited resources that some insurers may have for implementation work of two very complex and resource-demanding Standards
- Risk of inappropriate accounting arising from a transfer of assets where two different Standards are used
- Helpful to distinguish between changes in the insurance industry reported results/accounting mismatches that will survive on adoption of the new insurance contracts Standard, and those that will not
- Most of the feedback is from preparers
- Some jurisdictions outside Europe consider that any deferral should be optional

# Use of IFRS 4 to address the consequences of applying IFRS 9 before the new insurance contracts Standard

## Reduction in accounting mismatches

- Application of IFRS 9 could change the extent of accounting mismatches because of the new classification requirements and accounting policy choices

- If discount rate changes in profit or loss or OCI, the new Standard reduces mismatches between insurance contracts measured at cost and assets at FVPL or FVOCI

- Possible change in classification from AFS or AC to FVPL. Under IAS 39 changes in value of entity's share of underlying items reported in OCI (if AFS) or not re-measured (if AC). Volatility would be adjusted in the CSM if the variable fee approach is applied

- Mismatches can be reduced by using shadow accounting or current interest rates. The scope of shadow accounting could be extended beyond the current IFRS 4 application if that is deemed to address post IFRS 9 issues ahead of the new Standard OCI solution becoming available

# Use of IFRS 4 to address the consequences of applying IFRS 9 before the new insurance contracts Standard

## Reduction in accounting mismatches (cont.)

- IFRS 4 permits a change in accounting policies if this makes the financial statements more relevant to economic decision-making needs (IFRS 4 paragraph 22)

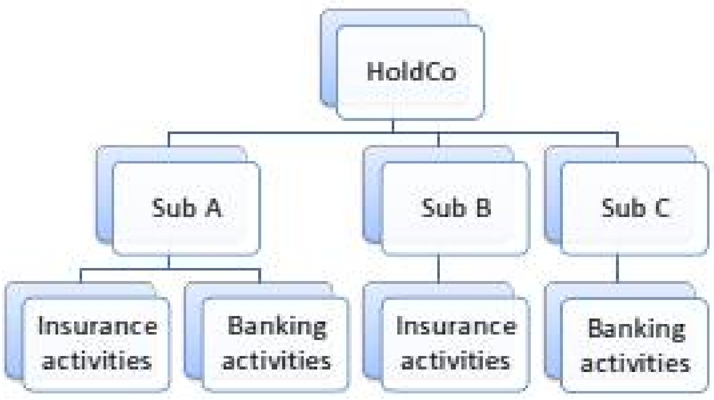
- Remaining accounting mismatches could be reduced by amending IFRS 4:
  - Allow an adjustment that results in recognising gains and losses on insurance contract liabilities that would offset unrealised gains and losses on the assets
  - Permit a liability adjustment to reflect the changes in the value of assets to the extent that these are recognised in profit or loss

- Any modifications could be optional, and would be subject to IASB's due process

# Use of IFRS 4 to address the consequences of applying IFRS 9 before the new insurance contracts Standard

## IASB discussion

- Need to distinguish between economic and accounting mismatches, with appropriate disclosures
- Flexibility in the application of shadow accounting such that this is applied to 100% of the backing assets, or to extend this to contracts without participation features that are economically linked
- Shadow accounting is directionally consistent with the variable fee approach
- Develop the variable fee approach, with companies early adopting this prior to fully implementing the new insurance contracts Standard
- The IASB Staff used this picture to highlight the complexity of the IFRS 9 solutions



# Complexity of deferring the effective date of IFRS 9 for the insurance industry

## Scope of deferral, presentation and disclosures, and accounting consequences

### 1. Deferral at reporting level

- Least complex, and would not contradict the provisions of IAS 8 and IFRS 10
- Some insurance activities not eligible and/or some banking activities eligible
- Conditions are whether the entity issues insurance contracts in the scope of IFRS 4, whether those are significant or it is a regulated insurance entity. Guidance will be given on these conditions
- Presentation and disclosures if there is a mandatory or optional deferral

### 2. Deferral at legal entity level

- Significantly more complex
- Additional issues - existence of IAS 39/IFRS 9 in consolidated financial statements
- Presentation and disclosures - application of deferral, use of IAS 39 & IFRS 9 in a single entity, asset transfers between entities that apply different financial instrument Standards and different time of applying IFRS 9 by legal entities

### 3. Deferral for insurance activities

- Most complex
- May not require significant assessment
- Need to determine how to capture insurance activities below the level of a legal entity, and which financial assets belong to those activities

# Complexity of deferring the effective date of IFRS 9 for the insurance industry

## IASB discussion

- Difficulties will arise if there were disclosures about seven measurement categories of assets that would be necessary if IAS 39 (four categories) and IFRS 9 (three categories) were applied at the same time
- Regulators may be concerned at the creation of a competitive disadvantage if different dates were permitted for the adoption of IFRS 9
- The IASB cannot prevent transfers of financial assets between insurance and other activities by prohibiting them in an IFRS. Requirements will be needed for such transfers

# The next steps

## Remaining technical decisions and publication date

- The IASB is expected to consider the remaining technical issues during the remainder of 2015
- In particular, whether the differences between the general model and the variable fee approach can be / need to be eliminated and whether the IFRS 9 effective date for insurers should be deferred to be effective when the new Standard on insurance contracts is effective
- The mandatory effective date of the new Standard will not be decided until after the IASB has concluded its deliberations in 2015
- The new Standard is expected to be published in 2016
- Deloitte believes that it is more likely than not that the delay suffered to date will lead the IASB to choose 1 January 2020 as the effective date, one year later than our previous estimate. This is because of the commitment to give insurers approximately three years to implement the new Standard since its publication date

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