

# Insurance alert

## IASB education session on May 19, 2015

*Since a variety of viewpoints are discussed at IASB meetings, and it is often difficult to characterize the IASB's tentative conclusions, these summaries may differ in some respects from the actions published in the IASB Observer notes. In addition, tentative conclusions may be changed or modified at future IASB meetings. Decisions of the IASB become final only after completion of a formal ballot to issue a final standard.*

### Highlights

At this education session the IASB continued its discussions on participating contracts and specifically discussed components of the variable fee approach for direct participation contracts and the accounting for 'indirect participation contracts', such as US style universal life contracts. The Board did not make any decisions.

The Board discussed whether contracts that provide for mutualisation between policyholders can be aggregated for purposes of determining the contractual service margin ("CSM") if they meet specific criteria. Diversification of risk and the application of discretion would not meet these criteria. The principle of mutualisation does not override the objective in the standard that the CSM should be fully released at the end of the contract term. The staff noted that they do not intend to provide additional guidance on application of the concept. The staff was asked to investigate whether mutualisation could also be applicable in contracts that do not qualify for the variable fee approach.

The staff proposed not to make any specific adaptations for the presentation of revenue for participating contracts, and noted that these contracts often have an explicit investment component, which would be straightforward to exclude from revenue.

The Board discussed the transition approach for participating contracts and whether any additional simplifications should be provided. The staff also suggested an approach for the determination of accumulated other comprehensive income ("OCI").

For indirect participating contracts, the Board had mixed views on whether current or locked-in rates should be used for the accretion of interest

on the CSM and the calculation of the present value of the changes that are recognized in the CSM. The staff proposed a level yield version of the effective yield approach, rather than the projected crediting rate that was proposed in an earlier meeting. The Board expressed mixed views on the suggested approach.

For contracts with participation features the Board discussed whether it should allow an accounting policy choice to recognize changes in discount rates either in profit or loss or in OCI similar to the general model. No clear views were expressed.

For contracts that qualify for the current period book yield approach, where the asset yields are mirrored in the income statement, the staff proposed to also allow the use of an effective yield approach. The Board was skeptical about allowing the effective yield approach.

The Board expressed concerns that throughout the standard too many options and accounting policies are provided, which diminish understandability and comparability.

The Board also briefly discussed the interaction between IFRS 9 for financial instruments and the insurance contracts project. The staff noted that the information received so far is too high level to understand the underlying issues for preparers. The staff will continue to monitor the developments and provide updates to the IASB as necessary.

The staff papers note that during the remainder of 2015 the IASB will work on the remaining technical decisions. It is expected that the new standard will not be published before the end of 2015.

## Variable fee approach: level of aggregation

One of the key outstanding items in the model for participating contracts is the level of aggregation.

The level of aggregation does not affect the measurement of the fulfilment cash flows, however, it affects the measurement of the CSM and thus the timing of recognition of underwriting gains and losses in profit or loss, including initial and subsequent loss recognition.

The staff introduced the concept of mutualisation for contracts that qualify for the variable fee for service model ('direct participation contracts'). The application of mutualisation will result in a higher level of aggregation for insurance contracts meeting specified criteria.

Mutualisation refers to a contractual requirement to:

1. share with other policyholders in the returns of the same specified pool of underlying items; and
2. reduce the share of return on a policy as a result of payment to other policyholders that share in that pool; or
3. reduce the share of return on a policy of other policyholders if a guarantee is in the money.

In other words, the expenses, including the guarantees to a particular group of policyholders, are borne by other policyholders.

The Board distinguished mutualisation as discussed above from diversification of risk and the application of discretion. Mutualisation should be contractual, whereas discretion and diversification may be applied without an explicit contractual arrangement. One of the Board members noted that when an entity applies discretion, it uses money from its own pocket to share that with other policyholders. This is different from a contractual sharing mechanism between policyholders.

The Board commented that the concept of mutualisation shall only be applied for the purposes of CSM measurement. It does not override the requirement to fully release the CSM when the contract has expired. The staff did not explain how this objective would be met in practice in combination with mutualisation, but noted that entities should come up with an appropriate method.

One Board member noted that certain contracts in a mutualized group of contracts could be loss making and as a result of using a higher level of aggregation this fact will not be apparent to the users of the financial statements. Though the higher level of aggregation could be appropriate for measurement purposes, he requested additional disclosures to ensure that the financial statements provide sufficient information on onerous contracts. He was mainly concerned that these loss-making contracts could at some point make the entire group of contracts onerous and users should be made aware of that. Other members pushed back and questioned why the disclosures should be at a more granular level than measurement.

One Board member commented that the concept of mutualisation could be applicable not only to direct participation contracts. The staff was asked to assess the concept of mutualisation for other participation contracts as well. In addition, the staff clarified that the concept of mutualisation is not restricted to guarantees, but may also apply to, for example, mortality experience.

## Variable fee approach: revenue

The staff noted that no adaptations to the measurement of revenue are needed specifically for the variable fee for service model. As in the general model, revenue from insurance contracts represents the consideration to which the entity expects to be entitled in exchange for services provided and should exclude investment components. The staff noted that contracts with direct participation features frequently contain an explicit investment component, which simplifies excluding the investment component. In substance, the revenue to be recognized is the variable fee, i.e. the consideration to be received for the provision of services, adjusted to reflect the time value of money.

## Variable fee approach: transition

The Exposure Draft ("2013 ED") and subsequent tentative decisions proposed a hierarchy of three possible transition approaches:

1. Full retrospective application;
2. Simplified retrospective application; or
3. Fair value approach.

The Board discussed the applicability of the approaches to contracts qualifying for the variable fee for service model.

### *CSM at the beginning of the earliest period presented*

The key difference with the general model is that the CSM in the variable fee approach is adjusted for changes in estimates of the variable fee for service.

The variable fee for service at the end of each reporting period is equal to the fair value of an entity's expected share of the returns of underlying items less the risk-adjusted expected present value of the net cost of providing the contract (including the costs of guarantees) less the amount of the CSM allocated to profit or loss.

The staff believes that retrospective application would often be impracticable for entities applying the variable fee approach because it would likely require the use of hindsight. The staff proposed that the IASB consider the following approaches:

Option 1: do not provide additional simplification for the variable fee approach which would generally assume applying the fair value approach for determining the CSM at the beginning of the earliest period presented.

Option 2: provide an additional simplification to the simplified approach and assume all changes in the variable fee for service were known at initial recognition. The CSM at initial recognition would be:

- a. the expected variable fee at the beginning of the earliest period presented, adjusted to reflect time value of money between the date of initial recognition and the beginning of the earliest period presented; and
- b. the payments of cash flows related to the variable fee that occurred before the beginning of the earliest period presented.

While one Board member advocated the fair value approach, another argued that the use of the fair value approach results in a lack of comparability with measurement of other liabilities that use a different transitional approach. The staff noted that the hierarchy was discussed in a previous meeting and that the fair value approach was not intended to be the first choice, rather it is supposed to be the last resort where other options are not available.

### *Current period book yield*

In the March 2015 meeting, the staff proposed a 'current period book yield approach' for a limited subset of participating contracts meeting specified criteria. Under this approach, interest

expense on the insurance contract liability should be an equal and opposite amount to the investment income on the underlying items that is reported in profit or loss. Any difference between the interest expense reported in profit or loss and the movement due to discounting using a current rate would be recognized in OCI.

Historical information might be needed to estimate the accumulated balance of OCI on transition. The staff proposed that entities should assume that the accumulated balance of OCI for the insurance contract is determined as follows:

- When underlying items are measured at fair value through profit or loss ('FVPL'), there would be no amounts accumulated in OCI.
- When underlying items are measured at fair value through OCI ("FVOCI"), the accumulated balance of OCI for the insurance contracts would be equal and opposite to the accumulated balance of OCI recognized for the underlying items.
- When underlying items are measured at amortized cost, the accumulated balance of OCI for the insurance contracts would be the difference between the amortized cost of the underlying items and their fair value.

One of the Board members commented that the suggested transitional approach appears to be a simple and good approximation to the retrospective application. Another member asked for illustrative examples to understand if the simplification would be a good proxy.

### **Accounting for indirect participation contracts**

The staff introduced the concept of a sub-category of participating contracts referred to as 'indirect participating contracts' which have cash flows that may vary with returns on assets, but the contract does not create an obligation to pay the policyholder an amount equal to underlying items less a variable fee. The most common example would be US style universal life contracts, for which amounts credited to policyholders (except for any minimum guarantee) are discretionary rather than contractual. The staff discussed the accounting model for these indirect participating contracts, focusing on changes in cash flows resulting from discretion, calculating and accreting interest on the CSM, and different potential versions of an effective yield calculation in calculating policyholder interest expense.

### *Changes in cash flows resulting from exercise of discretion*

The staff proposed that changes in estimates of cash outflows that arise as a consequence of changes in financial assumptions (for example changes in interest rates and asset gains or losses), and the corresponding change in discount rates, would be recognized in the statement of comprehensive income.

In contrast, changes in estimates that arise as a result of changes in the application of discretion, such as changes in the participation percentage for policyholder crediting, affect the consideration the entity will receive from the contract and adjust the CSM.

Some Board members noted that they agreed with the staff proposal but also observed that further clarification may be needed with regard to what constitutes discretion over cash flows that would be accounted for as an adjustment to the CSM. One Board member observed the complexity of having multiple models.

### *Use of locked-in or current discount rates*

In the variable fee for service model, the changes in the variable fee adjust the CSM, which in effect means that current rates are used for the accretion of interest on the CSM. In addition, the changes in fulfilment cash flows that adjust the CSM are calculated using current rates. The opening balance of the CSM is also re-measured to reflect changes in discount rates.

This is a difference compared to the general model for which the IASB confirmed in July 2014 that locked-in rates should be used.

The Board discussed whether locked-in or current rates should be used for indirect participating contracts and also briefly discussed whether that rate should be liability-based or asset-based.

One Board member noted that, except for the variable fee for service model, the CSM release is based on a set of future journal entries, rather than actual cash flows, which seemed to argue for a locked-in rate. Another member disagreed and characterized the CSM as a series of future outflows of services, arguing for a current rate.

Some preferred to have consistency with the variable fee for service model and would like to apply current rates to all insurance contracts. Others suggested an accounting policy choice or noted that the Board's starting point should be the general model, where locked-in rates are

applied. Overall there were mixed views on this topic.

In addition, the staff proposal to use a liability-based rate was challenged. From the discussion it was unclear what the Board's views were as the discussion mainly revolved around current and locked-in rates.

### *Interest expense in the statement of comprehensive income*

The 2013 ED proposed that, when some of the cash flows of an insurance contract vary with changes in expected investment returns, the discount rates applied to cash flows that vary with changes in expected investment returns are reset every time there are changes in estimates of those investment returns that result in changes in the amounts paid to policyholders.

In deliberations in 2014, for contracts with such discretionary crediting rates, the Board explored two versions of an effective yield approach. Both would be reset when there are changes in the amounts expected to be paid to policyholders due to changes in expected investment returns. However, the first version would be a level yield, calculated as a single rate that discounts expected future cash flows to the carrying amount of the liability. The second version of an effective yield, which was proposed by the staff, would calculate discount rates on a basis that reflects the entity's projected crediting rates. The difference between the effective yield and current discount rates would be recognized in OCI.

At the May 2015 meeting, the staff revised its view and proposed that the level effective yield approach rather than the projected crediting rate method should be used for indirect participating contracts.

One Board member noted that an effective yield approach that reflects the pattern of expected crediting rates provides a more relevant outcome than the level yield approach and the amounts in profit or loss and OCI are easier to explain. He expressed similar concerns for non-participating contracts when this was discussed in previous meetings. The staff noted that some preparers have indicated that the projected credit rate version is difficult to apply in practice.

## **Presentation of interest expense and OCI for contracts with participation features**

In March 2014 the IASB decided that for contracts without participation features, an entity should choose as its accounting policy to present the effect of changes in discount rates in profit or loss or in OCI.

At this meeting, the staff proposed allowing this accounting policy choice also for indirect and direct participating contracts. For contracts qualifying for the current period book yield approach (i.e. when the entity is holding the underlying items), the staff noted that complexity could arise once a portfolio of insurance contracts ceases to qualify for the current period book yield approach after inception. When it ceases to qualify for this approach an entity should be able to select an accounting policy for recognizing changes in discount rates in either profit or loss or in OCI using the effective yield approach.

Several Board members challenged why the effective yield approach would be allowed if contracts qualify for the current period book yield approach.

There were also more general concerns expressed about the number of options and accounting policy choices the Board is providing and the resulting lack of comparability. In response, one Board member suggested that the current book yield approach could be applied to indirect participating contracts as well. Other Board members strongly disagreed.

One Board member asked if the standard will provide guidance on some sort of threshold when an entity is effectively no longer holding the underlying items as this may be a difficult judgement in practice. The staff was not intending to include detailed guidance.

## **Update of the interaction between IFRS 9 Financial Instruments and Insurance Contracts project**

At the January 2015 meeting, the IASB noted that the effective date of the new insurance contracts standard is expected to be later than 1 January 2018 to allow for an approximate three year period between the issuance and effective date. Therefore, it would no longer be aligned with the effective date of IFRS 9 (1 January 2018). Accordingly, the IASB tentatively decided to consider providing additional transition relief to permit or require an entity to reassess the business model for managing financial assets when the new insurance contracts standard is initially applied.

In discussing those transition reliefs, the IASB noted that deferring the effective date of IFRS 9 would neither be appropriate nor feasible.

In May 2015, EFRAG issued its draft endorsement advice (DEA) for the use of IFRS 9 in the European Union (EU). EFRAG concludes that IFRS 9 satisfies the endorsement criteria and is conducive to the European public good. Accordingly, EFRAG recommends IFRS 9 for endorsement without further delay. In the DEA EFRAG advises that the European Commission ask the IASB to defer the effective date of IFRS 9 for insurance businesses and align it with the effective date of the new insurance contracts standard.

However, the DEA emphasizes that a more in-depth understanding of the magnitude of the potential effects of IFRS 9 being implemented in advance of the new insurance contracts standard is critical to the finalization of the endorsement advice to the European Commission and EFRAG therefore calls on constituents to provide more evidence and insights on this issue.

One Board member asked whether a holistic approach is taken and assets and liabilities are assessed together in the outreach. The staff noted that the information provided so far is high-level and it has been difficult to understand the underlying issues.

The staff will continue to monitor the developments and provide updates to the IASB as necessary.

**Contact us:**

If you would like to discuss any of the issues raised in these minutes, please call or contact Gail Tucker or Mary Saslow or speak with your usual contact at PwC.

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