Deloitte.

The accounting for indirect participating contracts remains an open issue

Only a number of small decisions reached this month

Francesco Nagari
Deloitte Global IFRS Insurance Lead Partner

26 November 2015

Agenda

- **Highlights of the IASB meeting on 18 November 2015**
- **Summary of the IASB Staff analysis, and IASB discussion and decisions**
- **Next steps**

Highlights

- The IASB did not reach a view on the Staff recommendation on the accounting for indirect participating contracts. The matter will be discussed again at a future meeting
- The **variable fee approach (VFA) should not be amended** to include financial guarantees embedded in the insurance contract in the underlying items.
- The **general model should not be amended** to require or permit the re-measurement of the CSM using current discount rates.
- An entity should be **permitted to measure at FVTPL** investment properties, investment in associates, owner occupied property, own debt and own shares if they are underlying items for a contract with direct participation features.
- The **restatement of the CSM under VFA will have its own transitional provision to simplify restatement**.
- The **option to recognise changes in the value of the guarantee embedded in the insurance contract in profit or loss should be applied prospectively** from the date of initial application of the Standard.

Comparison of the general model and the variable fee approach

Overview

Matters considered

- Similarities and differences between the general measurement model and the variable fee approach (VFA), and to whether they can be regarded as a single model.
- Confirmation that under the VFA the changes in fulfilment cash flows caused by guarantees embedded in insurance contracts should adjust the CSM before being recognised in profit or loss
- Agreement neither to require or permit the use of current discount rates for the re-measurement of the CSM in the general model.
- The accounting for indirect participating contracts which the IASB Staff handled by proposing a clarification of the general measurement model requirement for the unlocking adjustments of CSM when they include the effect of the insurer’s discretion.

Comparison of the general model and the variable fee approach

Overview

Matters considered (continued)

- Three narrow issues arising from the VFA:
  - extending the ability to permit an entity to measure some items underlying direct participating contracts at FVTPL in the same way as that exception is already permitted for unit-linked contracts;
  - simplifying the determination of the CSM on transition when it is measured using the VFA; and
  - how the option to recognise changes in the value of the guarantee in profit or loss instead of in the CSM applies on transition.

Comparison of the general model and the variable fee approach

Financial guarantees embedded in insurance contracts

Staff recommendation

- The VFA should not be amended to include financial guarantees embedded in the insurance contract in the underlying items.

IASB discussion and decision

- One IASB member considered that all financial guarantees would be better presented in profit or loss or failing this in OCI, rather than in CSM
- Other IASB members echoed the Staff concerns that this would create too much complexity as the entity would have to measure guarantees at each reporting date and the current book yield of the underlying assets would also be affected. Also such guarantees are not well defined in the current draft Standard.
- Many IASB members felt that, given the stage of the project, the need for a practical solution outweighed the possible ‘cliff effects’ from having two models.
- The Board approved the Staff recommendation with 12 IASB members voting in favour and 2 against.

Comparison of the general model and the variable fee approach

Re-measurement of the CSM using current discount rates

Staff recommendation

- The general model should not be amended to require or permit the re-measurement of the CSM using current discount rates.

IASB discussion

- The term ’re-measurement’ was discussed, and it was agreed that the term ‘accretion and unlocking at the current rates’ was more accurate.
- The IASB agreed with the Staff analysis that for the general model the CSM is a residual that does not reflect the current value of the future cash flows, as it uses the historical premium not the premium that would have been charged at the reporting date.
- This differs from the calculation of the CSM for VFA contracts, which uses current values of the underlying assets to re-estimate the future variable fees. Further, to accrete and adjust the CSM using current discount rates would result in recalculating the opening balance of CSM at each reporting period.

Comparison of the general model and the variable fee approach

Re-measurement of the CSM using current discount rates (cont.)

IASB discussion

- In the view of the Staff and some IASB members these 'catch up' adjustments would introduce complexity in the general model and are hard to explain because they do not relate to future cash flows. Some drew a parallel with not re-measuring the margin under IFRS 15.
- Other IASB members considered that unlocking and accreting at current rates is conceptually preferable given the long term nature of the contracts and the significant investment margins which could be part of the CSM.
- In their view the use of locked in rates requires the retention of historical data and creates a liability balance with different parts measured using different rates.
- Which 'current rate' would be used for accretion was also discussed and the alternatives were the rate used to discount fulfilment cash flows or the rate used under the VFA.

Comparison of the general model and the variable fee approach

Re-measurement of the CSM using current discount rates (cont.)

IASB discussion and decision

- Unlocking at current rates as an option was also considered, but IASB members found it difficult to narrow that option down or tie it to other accounting policy choices.
- IASB members were finally swayed by the argument that the tentative decision on allowing an accounting policy choice for presenting the effect of changes in discount rates in OCI only affected presentation, whereas an accounting policy choice on CSM accretion/unlocking would affect measurement.
- The Board approved the Staff recommendation with 10 IASB members voting in favour and 4 against.

Comparison of the general model and the variable fee approach

Treatment of discretion in participating contracts under the general model

Staff recommendation

- The effect of discretion to be recognised in the CSM under the general model is the change in the expected discretionary cash flows other than that which offsets the effect of a change in market conditions.

IASB discussion

- This recommendation relates to the issue of indirect participating contracts being excluded from the VFA and the fact that changes in the financial assets that the insurer uses to award policyholders with benefits that are effectively asset-dependent are not taken into account in the accounting for the CSM of those contracts.
- The VFA changes the CSM when the variable fees the insurer expects to receive have changed following changes in the clearly specified underlying items. However, the absence of clearly specified underlying items for indirect participating contracts leads the changes in expected variable fees from these contracts to be recognised in profit or loss (or split between P&L and OCI if OCI presentation is selected)

Comparison of the general model and the variable fee approach

Treatment of discretion in participating contracts under the general model (cont.)

IASB discussion

- Given that the asset-dependency of the cash outflows and the resulting variability of fees are both caused by the contractual discretion that characterises indirect participating contracts, the Staff proposed to analyse that feature to identify a solution.
- Four ways of viewing the contractual discretion were discussed.

a) Discretion could be seen as any changes of cash flows lower than the original expectation, subject to a minimum guarantee,

b) Discretion could be seen as the decision to award the return on the assets the entity holds (less a margin), subject to a minimum guarantee

c) The discretion is on the additional return above market conditions less a margin, subject to a minimum guarantee, and

d) Discretion covers all cash flows above the minimum guarantee.

Comparison of the general model and the variable fee approach

Treatment of discretion in participating contracts under the general model (cont.)

IASB discussion

- The Staff recommended view c). With this guidance the Staff attempts to avoid the changes in the discretionary outflows to distort the CSM balance and the net impact on P&L/OCI.
- For example to "burn out" the CSM through better than expected market conditions (e.g. increase of market interest rates). Equally "blow up" of CSM would happen when revisions are in the opposite direction (i.e. decrease of market interest rates).
- The proposed solution would split the change in expected cash flows to recognise in P&L/OCI the portion matching the change in market variables and unlock the CSM only with the residual change which would be the amount deemed discretionary in the overall expected pay-out to policyholders.
- In Deloitte's view, this interpretation of the contract does not acknowledge the reality of the insurer using its discretion to adjust its margin before the discretionary award to the policyholder in a similar way as in the VFA contracts

Comparison of the general model and the variable fee approach

Treatment of discretion in participating contracts under the general model (cont.)

IASB discussion

- One IASB member suggested the entity should state how it views its expected discretionary cash flows.
- At the outset it would specify the expected return from a mix of assets.
- The actual returns on that expected mix, and to the extent that a different amount is paid represents the exercise of discretion.
- Other IASB members preferred (b) on the basis that an insurer would typically exercise its discretion through the asset mix it holds.
- However, viewing an insurer’s promise of returns as based on the actual assets held would push indirect participating contracts into the VFA.

Comparison of the general model and the variable fee approach

Treatment of discretion in participating contracts under the general model (cont.)

IASB discussion and decision

- Some of the members supporting (b) were concerned that in the Staff paper the example for this view still showed a CSM balance when the contract was becoming onerous, and were also concerned with the degree of variable outcomes produced when scenario assumptions were changed.
- In particular, for longer duration assets when interest rates were increasing, the liability and the CSM were increasing but the insurer was not worse off if the underlying assets were paying variable rates.
- Given these concerns the Board was unable to decide on the Staff recommendation (with only 6 votes in favour being expressed) therefore this issue will be reconsidered at a future meeting.

Consequential issues arising from the variable fee approach

Measurement exceptions for items underlying contracts with direct participation features

Staff recommendation

- An entity should be permitted to measure at FVTPL investment properties, investment in associates, owner occupied property, own debt and own shares if they are underlying items for a contract with direct participation features.

.IASB discussion and decision

- After a brief discussion the Board unanimously approved the Staff recommendation, given the similarities between direct participating contracts and unit-linked contracts.

Consequential issues arising from the variable fee approach

CSM on transition for contracts measured using the variable fee approach

Staff recommendation

- In the simplified retrospective transition approach, at the date of transition an entity would measure contracts accounted for using the VFA as:
  - the fair value of the entity's share of the returns from underlying items;
  - less the current estimate of the remaining net cost of providing the contract adjusted to reflect costs already incurred;
  - less the accumulated fee for services provided in past periods, determined by comparing the remaining coverage period with the total coverage period for the contract.
- An entity should restate the CSM in comparative periods by adjusting the CSM at the date of initial application assuming the total fee for the contract had not changed since the beginning of the earliest period presented other than for the allocation of the CSM over those prior periods (based on the passage of time).

Consequential issues arising from the variable fee approach

CSM on transition for contracts measured using the variable fee approach

IASB discussion and decision

- One member raised concerns about the simplified retrospective application approach, being:
  - whether it would take into account of bonuses and distributions that had occurred since the beginning of the earliest period presented;
  - whether it was appropriate that only the entity's share of returns from underlying items should be at fair value (rather than all of the underlying items); and
  - what practical guidance the Standard will include to explain how to estimate the CSM at initial recognition using simplified assumptions about cash flows, discount rates and risk adjustments.
- The Board agreed on the objective, but asked for the wording to be revisited to make reference to the fair value of all the underlying items less the restated fulfilment cash flows.
- The Board unanimously approved the Staff recommendation.

Consequential issues arising from the variable fee approach

How the option to recognise changes in the value of the guarantee in profit or loss instead of the CSM applies on transition

Staff recommendation

- An entity should apply the option to recognise changes in the value of the guarantee embedded in the insurance contract in profit or loss prospectively from the date of initial application of the Standard.

IASB discussion and decision

- One member stated that it would be better if the option should be applied from the beginning of the comparative period as this would aid comparability, and there was not a great risk of hindsight being used.
- Other members expressed concerns about this view. One member considered that, as insurers would know what the outcome was, this would influence their decisions on whether to apply the option or not. Another member stated that in order to avoid cherry picking an insurer would have to be required to act as if it had adopted the new Standard before it was actually adopted, which would be hard to justify in the light of the decisions made in respect of IFRS 9.
- The Board approved the Staff recommendation, with 13 IASB members voting in favour and one against.

Insurance contracts - The next steps

Remaining technical decisions and publication date

- The IASB plans to reconsider **the treatment of discretionary changes under the general model which is core to the accounting of indirect participation contracts** during either the December 2015 or the January 2016 meeting.
- The issue on unit of account that was anticipated to be discussed prior to the finalization of the public debate seems to have been taken out of the residual agenda items
- The Staff expects to ask the IASB to review the **due process steps** undertaken in developing the Standard to date during its January 2016 meeting.
- The **mandatory effective date** of the new insurance contracts Standard will be considered when the publication date of the Standard (which is expected to be in 2016) is more certain. This may be during the January 2016 meeting.

Contact details

Francesco Nagari
Deloitte Global IFRS Insurance Lead Partner
+852 2852 1977 fnagari@deloitte.co.uk

Keep IFRS Insurance Connected by:

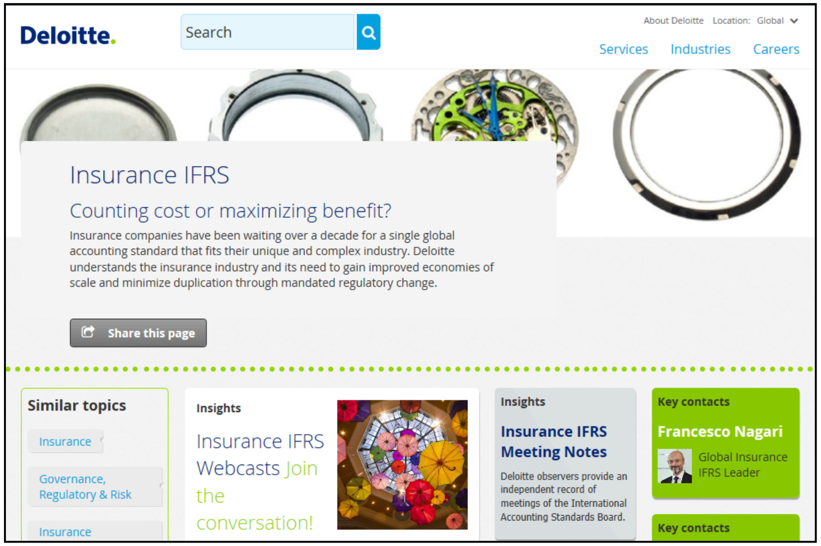
Follow my latest LinkedIn posts

Follow me on @Nagarif

Subscribe to Insights into IFRS Insurance Channel on YouTube

Connect to IFRS Insurance LinkedIn Group for all the latest IFRS news

Add Deloitte Insights into IFRS Insurance (i2ii) www.deloitte.com/i2ii to your favourites



Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.