STAFF PAPER

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Project	**Insurance Contracts**
Paper topic	Consequential issues arising from the variable fee approach

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Introduction

1. This paper considers the following three narrow issues arising from the variable fee approach:

   (a) *Issue 1:* an extension of an existing exception to permit an entity to measure some assets underlying unit-linked contracts at fair value through profit or loss so that the exception also applies when those assets underlie contracts with direct participation features. This issue is discussed in paragraphs 4-12;

   (b) *Issue 2:* the determination of the contractual service margin for variable fee contracts on transition to the new insurance contracts Standard. This issue is discussed in paragraphs 13-19; and

   (c) *Issue 3:* how the option to recognise changes in the value of the guarantee embedded in insurance contract in profit or loss instead of in the contractual service margin applies on transition to the new insurance contracts Standard. This issue is discussed in paragraphs 20-25.

2. Agenda paper 2 provides background information about the variable fee approach, and Agenda paper 2A considers the differences between the general model and the variable fee approach.

Staff recommendations

3. The staff recommend that:

   (a) *for Issue 1:* an entity should be permitted to measure at fair value through profit or loss investment properties, investments in associates, owner occupied property, own debt and own shares if they are underlying items for a contract with direct participation features. This would extend the existing exceptions that permit an entity to measure those assets underlying unit-linked contracts at fair value through profit or loss that are:

      (i) available in other IFRS (ie for investment properties and investments in associates); and

      (ii) proposed in the 2013 ED (ie for owner occupied property, own debt and own shares);

   (b) *for Issue 2:*

      (i) in the simplified retrospective transition approach, at the date of initial application of the new Standard, an entity should measure a contract accounted for using the variable fee approach as:

         1. the fair value of the entity's share of the returns from underlying items;

         2. less the current estimate of the remaining net cost of providing the contract adjusted to reflect costs already incurred;

         3. less the accumulated fee for service provided in past periods, determined by comparing the remaining coverage period with the total coverage period of the contract.

      (ii) An entity should restate the contractual service margin in comparative periods by adjusting the contractual service margin at the date of initial application assuming the total fee for the contract had not changed since the beginning of the earliest period presented;

(c) *for Issue 3:* 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.

Issue 1: measurement exception for underlying items in contracts with direct participation features

4. Issue 1 considers whether the existing and proposed exceptions that permit an entity to measure investment properties, investments in associates, owner occupied property, own debt and own shares at fair value through profit or loss when those assets underlie unit-linked contracts should be extended so that the exceptions also apply when those assets underlie contracts with direct participation features.

Background

5. The 2013 ED proposed to permit the following assets underlying unit-linked funds[1] to be measured at fair value through profit or loss:

   (a) owner-occupied property accounted for applying IAS 16 *Property, Plant and Equipment*;

   (b) own shares accounted for applying IAS 32 *Financial Instruments: Presentation*; and

   (c) own debt accounted for applying IFRS 9 *Financial Instruments*.

   Those proposals and the IASB's reasoning for those proposals are reproduced in paragraphs A2 and A3 of Appendix A.

6. Those proposals are consistent with existing exceptions in IFRS for assets underlying unit-linked contracts. Those existing exceptions are intended to address accounting mismatches between the obligation in unit-linked contracts and:

[1] Unit-linked funds were defined in the 2010 ED as a contract for which some or all of the benefits are determined by the price of units in an internal or external investment fund (ie a specified pool of assets held by the insurer or a third party and operated in a manner similar to a mutual fund).

(a) investment properties accounted for applying IAS 28 *Investments in Associates and Joint Ventures* (paragraph 18), or

(b) investments in associates in IAS 40 *Investment Property* (paragraphs 32A-32B).

Those exceptions are reproduced in paragraph A4 of Appendix A.

7. The exceptions that are discussed in paragraphs 5 and 6 are referred to collectively as ‘the exceptions’ for the remainder of this paper.

Staff Analysis

8. Unless specified by the IASB, the exceptions to measure assets at fair value through profit or loss would be applicable to direct participation contracts only if they are in the form of unit-linked contracts. However, not all contracts with direct participation features are in the form of a unit-linked contract. Nonetheless, the staff think that the reasons for the exceptions in other IFRS (see paragraph 6) also apply to contracts with direct participation features not in the form of unit-linked contracts because:

(a) direct participation contracts also have a contractual link to the underlying assets (see paragraph 9); and

(b) accounting mismatches will be reduced (see paragraphs 10-12).

Direct participation contracts have a contractual link to the underlying items

9. One reason for the exceptions to measure assets underlying unit-linked contracts at fair value through profit or loss is that unit-linked contracts have a contractual link to those assets. The entity may be required or choose to hold the assets referred to in the unit-linked contracts. Similarly, one of the criteria for a contract to qualify as a direct participation contract is that the contractual terms specify that the policyholder participates in a defined share of a clearly identified pool of underlying items. Consequently, the staff think that the situation in which an entity is required to hold or chooses to hold an asset which is part of the pool of underlying items is similar to the situation that the exception for measuring assets underlying unit-linked contracts at fair value was designed to address.

Accounting mismatch

10. For unit-linked contracts, the IASB concluded that there would be little benefit to require entities to separately identify its own shares, own debt and owner-occupied property, and the other exceptions, and not to account for them at fair value through profit or loss given that the returns to the policyholders are measured at fair value. Accounting for such assets at fair value would reduce accounting mismatches between the account for such assets and the obligation to the policyholder. Similarly, applying the variable fee approach, the obligation to the policyholder is the returns on underlying items that are also measured at fair value.

11. The staff note that, when applicable, the current period book yield approach could be used with the objective of reducing accounting mismatches in profit or loss between the gains and losses reported for the underlying items held and those arising from the obligation to the policyholders. However, providing the exceptions to measure assets at fair value through profit or loss for all direct participation contracts could be a less costly method for some entities to reduce accounting mismatches compared to applying the current period book yield approach, and would reduce accounting mismatches in a more comprehensive manner (ie for both profit or loss and equity).

12. Consequently, the staff recommend that the exceptions to measure assets at fair value through profit or loss should be extended to apply to all assets underlying contracts with direct participation features (ie it would not matter whether the contracts with direct participation features are in the form of a unit-linked contract).

Question 1: Measurement exception for underlying items in contracts with direct participation features
Does the IASB agree that an entity should be permitted to measure at fair value through profit or loss investment properties, investments in associates, owner occupied property, own debt and own shares if they are underlying items for a contract with direct participation features?

Issue 2: Contractual service margin on transition for contracts measured using the variable fee approach

13. Issue 2 considers the measurement of the contractual service margin in the simplified retrospective transition approach for contracts measured using the variable fee approach (ie contracts with direct participation features).

Background

IASB tentative decisions for transition for contracts measured using the general model

14. As previously discussed by the IASB, the issue on transition to the new insurance contracts standard is primarily related to how to determine the opening balance of the contractual service margin. In October 2015, the IASB tentatively confirmed that, on first application of the new insurance contracts Standard, all entities are required to restate comparative information about insurance contracts. Accordingly, the issue on transition to the new insurance contracts standard is primarily related to how to determine the contractual service margin at the beginning of the earliest period presented.

15. In October 2014 the IASB tentatively decided that:

    (a) on application of the new insurance contracts Standard, an entity should apply the Standard retrospectively in accordance with IAS 8 unless it is impracticable.

    (b) If retrospective application of the Standard is impracticable, an entity should apply a simplified retrospective transition approach that would enable entities to approximate retrospective measurement of the contractual service margin. In the simplified retrospective transition approach, an entity would determine the contractual service margin at the beginning of the earliest period presented by:

        (i) estimating the contractual service margin at initial recognition using simplified assumptions about the cash flows, discount rates and risk adjustment, and

(ii) estimating the accumulated amount of the contractual service margin allocated to profit or loss before the beginning of the earliest period presented.

(c) If the simplified retrospective transition approach is impracticable, an entity would determine the contractual service margin (or amount of loss) at the beginning of the earliest period presented as the difference between the fair value of the insurance contract and the fulfilment cash flows.

Staff analysis

16. In the variable fee approach, the contractual service margin at any point after initial recognition is the variable fee for the remaining service. It is determined as:

(a) The fair value of the entity's share of the returns from the underlying items;

(b) Minus the risk-adjusted expected present value of the estimate of the total net cost of providing the contract;

(c) Minus the accumulated fee for service provided in prior periods.

17. Applying the simplified retrospective transition approach, if an entity were to measure a contract accounted for using the variable fee approach at the date of initial application of the new Standard:

(a) the entity may not be able to determine the fair value of the entity's share of the returns from underlying items at the beginning of the earliest period presented without use of hindsight. This is discussed in paragraph 18.

(b) The entity would be able to estimate the total net cost of providing the contract by adding the costs already incurred to the current estimate of the remaining net cost of providing the contract.

(c) As the variable fee for service is recognised over the coverage period on the basis of the passage of time, the entity would be able to estimate the accumulated fee for service provided in past periods (and the unearned fee for service for future periods) by comparing the remaining coverage period with the total coverage period of the contract.

18. Because of paragraph 17(a), unless an entity had previously recorded the fair value of underlying items at the end of each reporting period before the date of initial application, the simplified retrospective transition approach may be impracticable for entities applying the variable fee approach because estimating historical fair value information would require the use of hindsight. To address this issue, the staff propose that an entity applying the variable fee approach should:

    (a) measure the contractual service margin *at the date of initial application* of the new Standard; and

    (b) calculate the amount of the contractual service margin for restated comparative periods by adjusting the contractual service margin at the date of initial application assuming the total fee for the contract had not changed since the beginning of the earliest period presented.

19. The example below illustrates how an entity could apply this simplification.

> Example
>
> At the date of initial application,
> (a) an entity has a portfolio of identical contracts, all in the tenth year of a fifteen year coverage period.
> (b) the fair value of the entity's share of underlying items is CU219.
> (c) the current estimate of the remaining net cost of providing the contracts is CU 6 and the entity has already incurred costs of CU15 in the first 10 years of the coverage period. Thus the total net cost of providing the contracts is expected to be CU21.
> Assume time value of money is not significant.
>
> Accordingly, the contractual service margin at the date of initial application is determined to be CU(219-21)*5/15 = CU66.
>
> The entity presents comparative information for one year. To determine the contractual service margin for the prior period, the entity assumes that the contractual service margin at the beginning of the prior period is CU66 divided by five (15 years-10 years) X 6 (15 years – 9 years) = 79.2.

Question 2: Contractual service margin on transition for direct participation contracts

Does the IASB agree that:

(a) in the simplified retrospective transition approach, at the date of initial application, an entity should measure a contract accounted for using the variable fee approach as:

(i) the fair value of the entity's share of the returns from underlying items;

(ii) less the current estimate of the remaining net cost of providing the contract adjusted to reflect costs already incurred;

(iii) less the accumulated fee for service provided in past periods, determined by comparing the remaining coverage period with the total coverage period of the contract.

(b) an entity should restate the contractual service margin in comparative periods by adjusting the contractual service margin at the date of initial application assuming the total fee for the contract had not changed since the beginning of the earliest period presented?

Issue 3: How the option to recognise changes in the value of the guarantee in profit or loss instead of the contractual service margin applies on transition

20. Issue 3 considers how the option to recognise changes in the value of the guarantee in the profit or loss rather than as an offset in the contractual service margin applies on transition to the new Standard.

Background

21. Paragraphs 14 and 15 provide background about transition to the new insurance contracts Standard.

22. Agenda paper 2 provides background about the variable fee approach. In particular paragraph 21 of Agenda Paper 2 describes an exception for an entity applying the variable fee approach when the entity uses a derivative measured at fair value through profit or loss to mitigate the financial market risk from a guarantee embedded in an insurance contract.

Staff analysis

23. Unless the IASB specifies otherwise, an entity that applies the option to recognise changes in the value of the guarantee in profit or loss rather than as an offset in the contractual service margin could apply that option retrospectively. However, an entity applying this option is required to document its risk management objective and the strategy for mitigating the risk before doing so.

24. This documentation requirement is analogous to the documentation requirements in the hedge accounting requirements in IFRS 9. When considering the hedge accounting requirements in IFRS 9, the IASB concluded that it is not possible to designate a hedging relationship retrospectively without using hindsight. Consequently IFRS 9 prescribes prospective application of the hedge accounting requirements from the date of the first application of the Standard. As similar considerations apply to the documentation of risk management objective and strategy for mitigating risk, the staff propose that the IASB should similarly

require prospective application of the option to recognise changes in the value of the guarantee in profit or loss from the date the Standard is initially applied.

25. The staff note that an entity:

(a) would not be able to prepare the documentation before the Standard is issued. This is because the documentation defines the risk mitigation strategy in the context of the application of the Standard, and therefore cannot be applied before that Standard is applied;

(b) may be able to prepare the documentation after the Standard is issued and before the Standard is effective; and

(c) would be able to prepare the documentation from the date that the Standard is effective, ie the date that the entity first applied the Standard.

Question 3: How the accounting exception related to risk mitigation applies on transition
Does the IASB agree that 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?

Appendix A: Relevant extracts from the Basis for Conclusions on the 2013 ED, consequential amendments from the 2013 ED and the relevant requirements from IAS 28 and IAS 40

A1. This appendix sets out the relevant sections in relation to Issue 1 of this paper:

(d) measurement exception for assets proposed for own debt in IFRS 9, own shares in IAS 32 and owner occupied property in IAS 16 from the 2013 ED (see paragraph A2) and the 2013 ED Basis for Conclusions (see paragraph A3); and

(e) the relevant existing exceptions for investment in associates in IAS 28 and investment properties in IAS 40 (see paragraph A4).

A2. The relevant consequential amendments from the 2013 ED:

IAS 16 *Property, Plant and Equipment*

Measurement after recognition

(…)

29A Some entities operate, either internally or externally, an investment fund that issues notional units in linked contracts. As part of the entity's asset pool, these funds may include owner-occupied properties. An entity shall apply this Standard to such owner-occupied properties held. In addition, it may elect to measure those properties at fair value with the changes presented in profit or loss in accordance with the requirements of IAS 40 for investment properties measured at fair value.

IAS 32 *Financial Instruments: Presentation*

Scope

Treasury shares (see also paragraph AG36)

33 If an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from equity, unless paragraph 33A applies. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments that have been deducted from equity. Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity.

33A Some entities operate, either internally or externally, an investment fund that issues notional units in linked contracts. As part of the entity's asset pool, these funds may include treasury shares. The entity may elect not to apply the requirements of paragraph 33 to these treasury shares. Instead, it can elect to recognise and present these treasury shares as issued equity and as a corresponding financial asset.

IFRS 9 *Financial Instruments*

3.3 Derecognition of financial liabilities

(…)

3.3.4A Some entities operate, either internally or externally, an investment fund that issues notional units in linked contracts. As part of the entity's asset pool, these funds may include the entity's own financial liabilities (for example, corporate bonds issued). The entity may elect not to derecognise its own financial liabilities that are included in such an asset pool. Instead, it can elect to recognise and present such instruments as financial liabilities and recognise a corresponding financial asset. An entity shall measure the resulting financial asset at fair value through profit or loss.

A3. The relevant 2013 ED Basis for Conclusions paragraphs:

Interest Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items (paragraphs 33-34, 66 and BC83-BC87)

BC49 The 2010 Exposure Draft further proposed to eliminate some particular accounting mismatches by proposing that the entity's own shares and owner-occupied property should be recognised and measured at fair value for unit-linked contracts (see paragraph BCA153(c)). That proposal is inconsistent with the IASB's general principle that the accounting for assets that the entity holds should not be affected by the entity's other assets and liabilities. However, respondents noted that, for many contracts that specify a link to returns on underlying items, those underlying items include a mix of assets. With the exception of own shares, own debt and owner-occupied property, respondents believed that those assets would all be measured at fair value through profit or loss. Thus, respondents believed there would be little benefit in an entity separately identifying its own shares, own debt and owner-occupied property and account for them differently, given that the returns to the policyholders are measured at fair value. Furthermore, the same effect on equity would be achieved for such contracts when either:

(a) the recognition and measurement basis of the entity's own shares, own debt and owner-occupied property is adjusted to be consistent with the liability, as proposed in the 2010 Exposure Draft; or

(b) the measurement of the liability is adjusted to be consistent with the measurement basis of the entity's own shares, own debt and owner-occupied property, as would be the case when paragraph 34 of this Exposure Draft is applied.

Accordingly, the IASB confirmed its proposal that an entity should be permitted to recognise and measure its own shares and owner-occupied property at fair value with the changes recognised in profit or loss. The IASB also extended this proposal to an entity's own debt, and to unit-linked contracts that are not insurance contracts. The IASB noted that doing so would be consistent with existing exemptions in IFRS, for example, in IAS 28 *Investments in Associates* for unit-linked contracts. However, in contrast to the FASB, the IASB does not propose any other specific requirements for unit-linked contracts. The FASB proposes specific requirements and exemptions for segregated fund arrangements (ie participation features within insurance contracts that are contractually linked to segregated accounts and that meet specific criteria) and the related segregated portfolios of assets, which are similar to unit-linked contracts.

BC50 The IASB does not think that it would be feasible to eliminate all accounting mismatches by modifying the accounting for all underlying items so that they are measured at fair value, other than for most unit-linked contracts. Many contracts specify a link to the performance of a business unit that includes items such as goodwill in subsidiaries, deferred tax assets or pension liabilities, and determining and understanding the fair value of such items for this purpose would be unduly onerous. Furthermore, most fair value options in IFRS require that fair value changes should be recognised in profit or loss. Since this Exposure Draft proposes that part of the change in insurance contracts would be recognised in other comprehensive income, this would mean that there are only limited circumstances in which an entity could eliminate mismatches in both measurement and presentation of the insurance contract through the exercise of fair value options. Accordingly, the IASB developed the proposals in paragraph 34 that would increase the circumstances in which it would be possible to eliminate accounting mismatches by modifying the accounting for the insurance contract.

A4. The relevant requirements from IAS 28 and IAS 40:

IAS 28 *Investments in Associates and Joint Ventures*

Exemptions from applying the equity method

18 The Standard also provides exemptions from applying the equity method when the investment in the associate or joint venture is held by, or is held indirectly through, venture capital organisations, or mutual funds, unit trusts and similar entities including investment-linked insurance funds. Those investments in associates and joint ventures may be measured at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*.

IAS 40 *Investment Property*

Measurement after recognition

Accounting policy

32A An entity may:

(a) choose either the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property; and

(b) choose either the fair value model or the cost model for all other investment property, regardless of the choice made in (a).

32B Some insurers and other entities operate an internal property fund that issues notional units, with some units held by investors in linked contracts and others held by the entity. Paragraph 32A does not permit an entity to measure the property held by the fund partly at cost and partly at fair value.