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STAFF PAPER

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Project	**Insurance Contracts**		
Paper topic	Variable fee approach		
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Purpose and structure of the paper

1. This paper discusses the following topics:
   (a) the definition of an insurance contract with direct participation features (which sets the scope for the variable fee approach); and
   (b) the limited applicability of the risk mitigation exception.

2. This paper does not discuss reinsurance contracts held. Questions about the scope of the variable fee approach and accounting to reflect risk mitigation in respect of reinsurance contracts held will be discussed in a paper at a future meeting of the International Accounting Standards Board (Board).

3. For each topic, this paper provides:
   (a) an overview of the requirements in IFRS 17 *Insurance Contracts*;
   (b) a summary of the Board's rationale for setting those requirements, including an overview of the Board's previous discussions;
   (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued; and
   (d) the staff analysis, recommendation and questions for Board members.

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Summary of staff recommendations

4. The staff recommend that the Board should not amend the requirements in IFRS 17 for the following topics:

   (a) the definition of an insurance contract with direct participation features; and

   (b) the limited applicability of the risk mitigation exception.

Definition of an insurance contract with direct participation features

IFRS 17 requirements and rationale

5. IFRS 17 distinguishes between insurance contracts with and without direct participation features. The general model for insurance contracts without direct participation features is modified for insurance contracts with direct participation features—those contracts are measured applying modified requirements referred to as the 'variable fee approach'.

6. The variable fee approach was developed as part of the Board's thinking on how to account for insurance contracts with participation features. Many insurance contracts include participation features, whereby policyholders share in the returns of underlying items. The Board discussed the treatment of participation features extensively during the development of IFRS 17, resulting in the following requirements:

   (a) the fulfilment cash flows of *all* insurance contracts with participation features include the effect of policyholders' participation—the estimates of future cash flows include the expected effect of the returns on underlying items and the discount rate applied to the future cash flows reflects the variability of those returns;[1] and

   (b) for insurance contracts with *direct* participation features, additional adjustments are made in the subsequent measurement of the contractual

[1] Alternatively, the estimates of future cash flows are adjusted to reflect the variability of the returns and discounted at a risk-free rate.

service margin (the variable fee approach) compared to those made for insurance contracts without direct participation features (the general model).

7. The Board developed the variable fee approach for contracts with direct participation features in response to feedback that identified some insurance contracts as being substantially investment-related service contracts. In these contracts, the entity is promising an investment return based on underlying items, in effect providing an asset management service. The obligation to the policyholder can be regarded as a promise to return the underlying items to the policyholder, after deducting a variable fee.

8. The definition of insurance contracts with direct participation features identifies contracts with the characteristics described in paragraph 7 of this paper. They are insurance contracts for which, on inception:

    (a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;

    (b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns from the underlying items; and

    (c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

9. For these contracts, the Board concluded that to provide a faithful representation of the variable fee, the subsequent measurement of the contractual service margin (and hence revenue) should, in addition to the adjustments required under the general model:

    (a) include the entity's share of the changes in the fair value of the underlying items;

    (b) include the change in the effect of the time value of money and financial risk not arising from the underlying items (for example, the effect of financial guarantees); and

(c) be recognised in profit or loss as insurance *and investment-related services* are provided.[2]

10. In developing the variable fee approach, the Board acknowledged that treating insurance contracts with direct participation features differently from insurance contracts without direct participation features adds complexity for users and preparers of financial statements. The Board noted that the requirements for the measurement of the fulfilment cash flows and the initial recognition of the contractual service margin are the same for both types of contract, and the differences are limited to the subsequent measurement of the contractual service margin. The Board was persuaded by stakeholders that those differences are necessary to provide a faithful representation of the different nature of the types of contract.

Concerns and implementation challenges expressed since IFRS 17 was issued

11. Some stakeholders are concerned that the scope of the variable fee approach is too narrow, resulting in economically similar contracts being accounted for differently. In their view some types of insurance contracts are economically similar to insurance contracts with direct participation features except that:

    (a) the relationship between investments and the insurance contract arises from a constructive rather than contractual obligation; and

    (b) the contractual terms do not specify a clearly identified pool of underlying items.

12. Those stakeholders expressed the view that specifying different accounting for insurance contracts with direct participation features and for insurance contracts without direct participation features results in unjustified differences in their accounting.

[2] In June 2018, the Board tentatively decided to propose an extension to the period over which the contractual service margin should be recognised from the period in which insurance services are provided to the period in which either insurance services or investment-related services are provided.

Staff analysis and recommendation

13. As discussed in paragraphs 5−10 of this paper, the Board developed the scope of the variable fee approach in response to feedback during the development of IFRS 17. The Board considered carefully both the circumstances in which it would be appropriate to have different accounting, and what that different accounting should be.

14. The variable fee approach is designed to give a faithful representation of contracts that meet the definition of insurance contracts with direct participation features. Consequently, the staff do not think it would be possible to amend the scope of the variable fee approach without also reconsidering the modifications to the general model that comprise the variable fee approach. Given the modifications are designed to fit the existing scope, the Board would need to consider whether:

    (a) different modifications would be necessary for a different scope for the variable fee approach; or

    (b) the variable fee scope and approach would be left unchanged and a new category of contract identified, with a separate scope and modifications.

15. Either approach is likely to add complexity to IFRS 17. The staff also observe that whatever the scope of any modifications to the general model, there would be differences between the accounting for contracts within the scope and those outside the scope.

16. Considering the specific features of contracts that stakeholders have argued should be allowed within the scope of the variable fee approach (see paragraph 11 of this paper), the staff observe:

    (a) the relationship between investments and the insurance contract arises from a constructive rather than contractual obligation—a fundamental aspect of the variable fee approach is that the entity's share of the underlying items is regarded as a *variable fee*. The Board decided that for this to be the case, the

contract needs to specify the fee, ie the relationship between underlying items and the amounts payable to the policyholders;[3] and

(b) the contractual terms do not specify a clearly identified pool of underlying items—such contracts cannot be regarded as in effect providing asset management services if there are no specified assets.

17. The staff think the definition of an insurance contract with direct participation features appropriately identifies those contracts for which the Board thought modifications to the general model were necessary because the contracts essentially provide asset management services in exchange for a fee that depends on the returns on the underlying items.

18. Accordingly, the staff recommend that the Board should not amend the requirements in IFRS 17 relating to the definition of an insurance contract with direct participation features. The staff observe that some of the concerns expressed about contracts that are not eligible for the variable fee approach relate to the recognition of the contractual service margin in profit or loss over only the period in which insurance coverage is provided, rather than a longer period in which other services might be provided. The staff will bring a paper to a future Board meeting discussing the period in which the contractual service margin is recognised in profit or loss under the general model.

Question 1 for Board members
Do you agree that the Board should not amend the requirements in IFRS 17 relating to the definition of an insurance contract with direct participation features?

[3] Applying paragraph 2 of IFRS 17, contract terms include all terms in a contract, explicit or implied. Implied terms in a contract include those imposed by law or regulation.

Limited applicability of the risk mitigation exception

IFRS 17 requirements and rationale

19. IFRS Standards treat insurance contracts and the financial assets an entity holds as separate items. IFRS 17 applies to insurance contracts and IFRS 9 *Financial Instruments* to financial assets.

20. During the development of IFRS 17, the Board considered whether to develop a bespoke solution for all hedging activities for insurance contracts. However, the Board observed that IFRS 9 includes some general hedge accounting options that entities can use to avoid accounting mismatches. Developing a bespoke solution for hedging activities for insurance contracts beyond what is already permitted applying IFRS 9 should form part of a broader project on accounting for risk management activities, and the issuance of IFRS 17 should not be delayed pending completion of that project.

21. Nonetheless, IFRS 17 does allow a choice in the treatment of the contractual service margin in the variable fee approach to address some risk mitigation activities, specifically if an entity mitigates the financial risks of insurance contracts with direct participation features using derivatives. Stakeholders had expressed concern that in such cases:

    (a) the change in the fair value of the derivative would be recognised in profit or loss applying IFRS 9; but

    (b) the change in the insurance contract, the risk of which was mitigated by the derivative, would adjust the contractual service margin applying IFRS 17.

22. In response to this feedback, the Board included in IFRS 17 an option for the entity in specified circumstances to recognise the effect of some changes in financial risk in the insurance contracts in profit or loss, instead of adjusting the contractual service margin.

23. The reason the Board decided to include this specific risk mitigation option in the variable fee approach is because the mismatch described in paragraph 21 of this paper is an accounting mismatch caused by the variable fee approach. For contracts under

the general model, the contractual service margin is not adjusted for the changes in fulfilment cash flows the derivatives are intended to mitigate. Hence, both the change in the carrying amount of fulfilment cash flows and the change in the value of the derivatives will be recognised in profit or loss,[4] so no accounting mismatch arises.

24. Consistent with the transition requirements for hedge accounting in IFRS 9, the Board concluded that retrospective application of the risk mitigation treatment would give rise to the risk of hindsight. In particular, the Board was concerned that because the application of the approach is optional, entities could choose the risk mitigation relationships to which it would apply with the benefit of knowing at transition how that relationship had developed. Consequently, IFRS 17, consistent with the transition requirements for hedge accounting in IFRS 9, requires prospective application of the risk mitigation option from the date of initial application of the Standard.

Concerns and implementation challenges expressed since IFRS 17 was issued

25. Consistent with the feedback during the development of IFRS 17, some stakeholders are still concerned that the approach to risk mitigation activities in IFRS 17 is too narrow. Those stakeholders are concerned that the risk mitigation exception in IFRS 17 can be used:[5]

    (a) only for insurance contracts with direct participation features.

    (b) only when the hedging instrument is a derivative—those stakeholders think that the risk mitigation option should be equally applied when other arrangements provide a similar economic hedging mechanism.

    (c) prospectively although risk mitigation arrangements may have been in place before the date of initial application of IFRS 17.

[4] As long as the entity does not use the OCI option.

[5] Stakeholders also expressed concern that the requirements in IFRS 17 for reinsurance contracts held do not adequately depict their role in risk mitigation. This paper does not discuss reinsurance contracts held. The treatment of reinsurance contracts held will be discussed in a paper at a future Board meeting.

Staff analysis and recommendation

26. The staff observe that—as discussed in paragraph 23 of this paper—the existing risk mitigation exception was intentionally designed to reduce accounting mismatches that would otherwise be introduced by the variable fee approach. It reduces such mismatches by allowing an entity to treat some changes in insurance contracts in the same way that they would be treated applying the general model. As such, the specific risk mitigation exception in IFRS 17 by definition cannot be applied to contracts accounted for applying the general model (ie insurance contracts without direct participation features).

27. The staff think that an amendment to IFRS 17 to extend a deliberately narrow exception to broader circumstances of other risk mitigation activities should be considered as part of a comprehensive review on providing information about risk mitigation activities. The Board is working on such a project. Any solution developed in the short term outside the Board's other work on risk management activities would likely cause significant loss of useful information relative to that which would be provided by IFRS 17 for users of financial statements by increasing complexity and by reducing comparability between entities. Such an amendment could also introduce inconsistencies with, and potentially override the requirements of, IFRS 9.

28. Accordingly, the staff recommend that the Board should not amend the non-transitional requirements in IFRS 17 relating to risk mitigation activities.

Question 2 for Board members
Do you agree that the Board should not amend the non-transitional requirements in IFRS 17 relating to risk mitigation activities?

29. The staff also think that an amendment to IFRS 17 to permit retrospective application of the risk mitigation option would cause significant loss of useful information relative to that which would be provided by IFRS 17 for users of financial statements, by creating a further inconsistency with IFRS 9. In addition, it may enable entities to 'cherry pick' favourable outcomes for designation and retrospective application, because of its optional basis.

30. Accordingly, the staff recommend that the Board should not amend the requirements in IFRS 17 relating to the prohibition of retrospective application of the risk mitigation option.

Question 3 for Board members
Do you agree that the Board should not amend the requirements in IFRS 17 relating to the prohibition of retrospective application of the risk mitigation option?