Project **Insurance Contracts**

Topic **Interest accretion residual/composite margins**

Purpose of this paper

1. This paper provides a brief follow-up on the topic of accreting interest to the residual (as part of the model tentatively selected by the IASB) and composite margin (as part of the model tentatively selected by the IASB), supported by a simple case study in agenda paper 1G (FASB Memorandum 51G).

Background

2. Last week, the boards discussed the topics on which they, at that point, had reached different tentative decisions. One of those topics was whether to accrete interest to the residual or composite margin.

3. When the boards talked about the accretion of interest, three issues came up:

   (a) should interest be accreted to those margin?.

   (b) if the answer to the previous question is yes, should the interest rate be locked-in or updated?

   (c) which interest rate should be used?

Should interest be accreted or not?

4. During their April meetings, the IASB answered the first question with 'yes' and the FASB answered it with 'no'. The boards discussed this difference in view at their joint meeting last week (see agenda paper 2B/FASB Memorandum 50B) and reaffirmed their previous decisions.

5. The next two questions are only relevant if the answer to this first question was ‘yes’.

Locked-in rate or updated rate?

6. If interest is to be accreted, the question is whether to use a locked-in rate determined at inception or a current rate (ie updated each period). Agenda paper 1G for this meeting (FASB Memorandum 51G) includes a brief analysis of that issue.

7. It appeared that the two views referred to in that paper are a consequence of how one conceptually looks at the run-off of the residual/composite margin:

   (a) the result of a system of present values of future cash inflows and cash outflows, determined at inception. This view uses the pattern of those cash flows (ie the cash flows determined at inception) to run-off the margin over the life of the contract. Therefore, only a rate locked-in at inception works, or

   (b) a piece of the premium (customer consideration), determined at inception as the balance of the present value of cash inflows and cash outflows. Because the margin is run-off as that balance, both a locked-in and updated rate can be used to accrete interest. But because the insurance contracts model is a current model, it would be more natural to use a current rate.

8. Because allocation of a residual and composite margin is arbitrary to a certain degree, we concluded that it would be difficult to say which of the views is better. The staff differ in their preferences on this matter.

Which rate should be used?

9. The principle for the discount rate is that it should reflect the characteristics of the liability. The purpose of the residual margin/composite is to reflect a margin in an insurance contract, determined at inception and allocated over time to profit or loss. This tells us about its characteristics that:

(a) it conceptually reflects a margin in the underlying contracts, so it shares the characteristics of cash flows generated by those contracts like timing, currency and liquidity.

(b) but because its amount is determined at inception, it does not depend on the future performance of assets in any way.

10. Therefore, the staff conclude that, considering the characteristics of a residual/composite margin, the rate applied to determine the interest accreted for a year should reflect the one-year rate in the appropriate currency for illiquid instruments that expose the holder to no or negligible credit risk.

11. That conclusion would apply regardless of whether one decides to use a locked-in rate or updated rates. For the former, the rate in the previous paragraph would be determined once (at inception). For the latter, it would be updated each reporting period.

Question 1 for the boards
If the proposed model accretes interest to the residual/composite margin, should the applied rate: a) be locked-in at inception, or b) be updated each reporting period?

Question 2 for the boards
Do you agree that the rate for accreting interest should reflect the one-year rate in the appropriate currency for illiquid instruments that expose the holder to no or negligible credit risk?