STAFF PAPER

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IASB Meeting

Project	Insurance contracts
Paper topic	Interest accretion on residual margin

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Introduction

1. This paper discusses whether an insurer should be required to accrete interest on the residual margin.
2. This paper:
   (a) sets out the proposals in the exposure draft *Insurance Contracts* (the ED) (paragraphs 4 – 5);
   (b) provides an overview of the responses to those views (paragraphs 6 – 10); and
   (c) presents a staff analysis (paragraphs 11 – 24).
3. We will not ask you to make any decisions at this meeting. Instead, we ask youto indicate any leanings you might have or if there is further analysis you would need before making a decision.

Proposals in the ED

4. Paragraph 51 of the ED proposed that:

> 51 An insurer shall accrete interest on the carrying amount of the residual margin, using the discount rate specified in paragraph 30 as determined at initial recognition.

5. Paragraphs BC131-BC133 set out the IASB's Basis for Conclusions on this proposal:

> BC131 Interest is accreted on a risk adjustment because the adjustment is always a current measure and so implicitly or explicitly reflects the time value of money. The draft IFRS proposes that interest also should be accreted on the residual margin for the following reasons:
>
> (a) At initial recognition, the residual margin can be viewed as an allocation of part of the transaction price, ie consideration paid or payable by the insurer's customer (the policyholder). Accreting interest is consistent with the proposals in the exposure draft *Revenue from Contracts with Customers*, which would require an entity to accrete interest on the transaction price (if material). The accretion of interest reflects the fact that the entity would rationally have charged a different cash amount if the contract had stipulated earlier or later payment by the customer. Thus, accretion of interest shows the effect of the financing separately from the revenue from goods or services.
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> (b) The residual margin is one part of an overall measure of the insurance contract and every other component of that measure reflects the time value of money, leading to subsequent accretion of interest. The accretion of interest on the residual margin is consistent with that fact.
>
> BC132 Because the residual margin is determined at inception and not adjusted subsequently, the Board proposes that the interest rate used to accrete

interest on the residual margin would be locked in at inception of the contract and not adjusted subsequently. Furthermore, the rate would be the discount rate used to discount the cash flows included in the measurement of the liability.

BC133 The Board considered the view of some who do not believe interest should be accreted on the residual margin, on the grounds of simplicity and because they view the residual margin as a deferred credit rather than as a representation of a component of an obligation. That view is supported by the FASB and applied to the composite margin in the FASB's preferred approach (see Appendix)[1]. However, the Board did not find that view persuasive.

Response to the proposals in the ED

6. Question 6(f) of the invitation to comment asked respondents:

> Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

7. Less than half of respondents addressed this question specifically. Of those that responded, views were mixed regarding the benefits of accreting interest on the residual margin.
8. Arguments in support of interest accretion included:

   (d) Accreting interest on the residual margin would reflect the unwinding of the premium received (which is a present value) over time.

   (e) All other elements of accounting for insurance contracts are measured using a present value basis, and therefore it would be consistent to reflect interest on what is the residual measure of a present value calculation. The residual

[1] The Appendix has not been reproduced in this paper

margin is itself a present value, as it is derived from two present value calculations.

(f) Failure to recognize the time value of money in the amortization of the residual margin will result in the reporting of excess investment margins (or if the premium is to be received in the future, then the interest income on the premium receivable would not be offset by interest expense on the residual margin)

9. Arguments against interest accretion included:

(g) Without identifying precisely what obligation a locked-in residual margin represents, and without measuring that obligation directly, the accretion of interest will be arbitrary and artificial.

(h) While conceptually consistent with the measurement model, the complexity involved in practice outweighs the benefits of such an approach.

(i) It is not useful to gross up the residual margin with interest by recognising an interest charge which will be released to profit again in a future period. This has the potential in early periods to increase the residual margin which these respondents do not believe is useful.

10. Other concerns regarding the calculation of interest were also raised, including:

(j) The residual margin is not a set of cash-flows, therefore it is not clear what rate on the yield curve should be used (discussed in paragraph 19).

(k) The use of a current interest rate vs the interest rate at inception. Many objected to using a historic discount rate as the underlying amounts are discounted with the current market interest rates (discussed in paragraph 20).

(l) Whether accretion of interest would be relevant for contracts accounted for using the premium allocation approach (which we will consider in a future meeting, together with other issues relating to the premium allocation approach).

Staff analysis

11. This analysis is structured as follows:

    (m) Whether to accrete interest on a locked in residual margin.

    (n) What rate should be used to calculate interest if interest is to be accreted.

    (o) Whether this paper is relevant if the residual margin is unlocked.

Whether to accrete interest on a locked-in residual margin

12. As noted in paragraph BC131(a) of the Basis for Conclusions on the ED, accreting interest on the residual margin is consistent with the proposals in the exposure draft *Revenue from Contracts with Customers*, which would require an entity to accrete interest on the carrying amount of a contract asset or contract liability. The accretion of interest reflects the fact that the entity would rationally have charged a different cash amount if the contract had stipulated earlier or later payment by the customer.
13. The Board's tentative decisions in the revenue project require the entity to allocate the transaction price to *identifiable* performance obligations and recognise revenue when it satisfies those identified performance obligations. In contrast, under the IASB's tentative decisions on insurance contracts the residual margin represents the difference between the present value of the premiums and the present value of the expected cash outflows at contract inception (ie the beginning of the coverage period).
14. As discussed in agenda paper 6B, it is not possible to define precisely the nature of the obligation represented by a locked-in residual margin and this means that the residual margin is a mixture of things. Thus, it is difficult to measure the residual margin subsequent to initial recognition directly and therefore agenda paper 6B proposes that the residual margin is measured on an allocated cost basis (agenda paper 6C discusses the allocation of the residual margin).
15. If the Board agrees with that analysis, then this paper proposes that interest is not accreted on a locked in residual margin. Because the recognition of the residual margin on an allocated cost basis is arbitrary, accreting interest on the carrying

amount would not represent the effect of financing separately from the future economic outflow. In addition:

(a) Not accreting interest would be consistent with a decision to not subsequently remeasure the residual margin for other changes in expected premiums. This contrasts with revenue recognition in which changes in the transaction price result in the reallocation of that transaction price between all performance obligations.

(b) Allocating the cost without accreting interest is much simpler.

16. However if the nature of the obligation that the residual margin represents can be identified, then the timing and amount of the future economic outflow can be estimated and the pattern of recognition would better reflect the satisfaction of that obligation. Thus, accreting interest on the obligation would show the effect of financing separately from the future economic outflow, consistent with the Board's tentative decisions on revenue recognition.

Question for discussion
Should interest be accreted on a locked-in residual margin?

What rate should be used to calculate interest

17. This section is relevant if the Board were to decide that interest should be accreted on a locked-in residual margin.

18. Some respondents questioned the rate used to determine the amount of interest accretion, including what point of the yield curve should be used and whether a current rate or the rate determined at contract inception should be used.

19. In the staff's view the rate should be consistent with the weighted average duration reflecting the pattern of amortisation of the residual margin. The staff thinks this would be consistent with the proposal in the exposure draft.

20. Regarding whether a current rate or the rate determined at contract inception should be used, the staff notes that:

a. A current rate is used for other components of the insurance obligation. Therefore, if the objective of accreting interest is to reflect the fact that the entity would rationally have charged a different cash amount if the contract had stipulated earlier or later payment by the customer, then a current rate should be used because this would be consistent with the rate used to accrete interest on any premiums receivable.

b. As noted in BC132, because the residual margin is determined at inception and not remeasured subsequently, the Board proposed that the interest rate used to accrete interest on the residual margin would be locked in at inception of the contract and not adjusted subsequently. The staff notes that a rate determined at contract inception would be consistent with the Board's tentative decisions for revenue recognition, where the rate used is locked at contract inception.

Question for discussion
Should interest be accreted using a current rate or a historic rate?

Is this paper relevant if the margin is unlocked?

21. Whether this paper is relevant for an unlocked residual margin will depend on how changes in estimates change the residual margin subsequent to initial recognition.
22. If the residual margin is subsequently adjusted on the basis of the expected present value of inflows and outflows at each reporting date, then the accretion of interest would be implicit in that adjustment. Therefore, in the staff's view, it would not be necessary to explicitly state that interest should be accreted.
23. If the residual margin is subsequently adjusted on the basis of changes in the cash flows discounted back to the time of initial recognition (ie to determine the residual margin that would have been determined had those estimates been made at initial recognition), then the accretion of interest would not be implicit in that adjustment and the analysis in this paper would be relevant.
24. Similarly if changes in the discount rate adjust the residual margin, then a current rate of accreting interest should be used (implicitly under paragraph 22, and

explicitly under paragraph 23). However, if changes in the discount rate do not adjust the residual margin, then the analysis in paragraph 20 would be relevant.

Question for discussion
Does the Board agree with this analysis?