STAFF PAPER

20 September –28 September

REG IASB Meeting

Project	**Insurance Contract**		
Paper topic	Residual Margin – Rate of accretion of interest		
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Introduction

1. Agenda paper 16B recommends that an insurer accretes interest on the residual margin. This paper discusses whether an insurer should accrete interest on the residual margin using the rate determined at inception ('locked-in rate') or a rate updated at each reporting period ('current rate').

2. This paper:

   (a) sets out the proposals in the exposure draft *Insurance Contracts* (the ED) (paragraph 5 - 6);

   (b) provides an overview of the responses to those views (paragraphs 7 - 10);

   (c) summarises key IASB decisions to date that affect the decision to accrete interest (paragraph 11); and

   (d) presents a staff analysis (paragraphs 12 -27).

3. The staff intends to discuss the accretion of interest under the premium allocation approach (PAA) at a future meeting.

Staff recommendation

4. The staff recommends that the IASB:

   (a) confirm the proposal in the ED that an insurer should accrete interest on the residual margin using the discount rate of the liability determined at initial recognition of the contract, ie the locked-in rate; and

   (b) does not provide further guidance on determining the discount rate to use when accreting interest on the residual margin.

Proposals of the Exposure Draft

5. The ED proposed that an insurer accrete interest on the carrying amount of the residual margin, applying the discount rate for the liability determined at initial recognition.

6. The Basis for Conclusion (BC) explained that the IASB decided to accrete interest using a locked-in rate, because the residual margin was determined at inception of the contract and was not subsequently remeasured.

Responses to proposals in the Exposure Draft

7. The ED asked respondents whether they agreed with the requirement to accrete interest on the residual margin using a locked-in rate.

8. Fewer than half of respondents discussed the accretion of interest on the residual margin. Of the respondents that addressed this question, many agreed with accretion of interest.

9. Some respondents agreed with the principle of accretion, but argued that a current rate may be more appropriate than a locked in rate. They stated that:

   (a) to be consistent with all the other components of the insurance contract liability, an insurer should accrete using a current rate. The discount rate for the other components of the liability is updated at each reporting period.

(b) the residual margin represents an unallocated component of the risk adjustment. Therefore, the risk adjustment and the residual margin should be measured on a consistent basis. Since the risk adjustment is measured on a current basis, interest on the residual margin should be accreted at a current rate.

10. Some requested that the IASB clarify how the discount rate used to accrete interest should be calculated. The residual margin represents a blend of cash flows. The insurer would be using different discount rates to discount the cash flows with different characteristics and timing (for example, different points of the yield curve are used depending on the timing of the cash flows).

Developments since the ED

11. Since the ED the IASB has re-deliberated various aspects of the proposals in response to the feedback received. The following areas are relevant when considering the appropriate rate at which to accrete interest:

(a) the residual margin will be unlocked for favourable and unfavourable changes in expected future cash flows only, and not for changes in the discount rate or changes in the risk adjustment. An insurer cannot reduce the residual margin below zero; and

(b) the effects of changes in discount rates shall be presented in other comprehensive income (OCI).

Staff analysis

12. The IASB could require an insurer to accrete interest on the residual margin using:

(a) the discount rate updated at each reporting period (‘current rate’) (discussed in paragraphs 14 -21); or

(b) the discount rate determined at inception (‘locked-in rate’) (discussed in paragraphs 22 - 24).

13. Regardless of whether a current or locked-in rate is used to accrete the margin, some respondents have requested that the IASB provide additional guidance on determining the rate because the residual margin is a blend of cash-flows. This is discussed further in paragraphs 25 - 27.

Current rate

14. By applying the current rate, an insurer would treat the residual margin consistently with the other components of the insurance liability. Other components of the liability are discounted using a current discount rate.

15. As mentioned in paragraph 6, the IASB originally decided to accrete interest using a locked-in rate, because the residual margin was determined on inception of the contract and was not subsequently remeasured. However, the IASB has subsequently decided that the residual margin should be unlocked for changes in estimates of expected future cash flows. Consequently, as the residual margin is no longer locked, it could be argued that the discount rate used to accrete interest should also be updated to reflect current rates. However, the staff note that the IASB has decided to unlock the residual margin for changes in expected future cash flows only. Changes in discount rates are not reflected in the residual margin.

16. If the IASB decided to accrete interest on the residual margin at a current rate, the IASB would also need to decide how to present that interest in the statement of comprehensive income.

17. The IASB has tentatively decided to present interest expense in profit or loss using the discount rate at inception (a locked-in rate). The effects of changes in the discount rate are presented in other comprehensive income (OCI). To be consistent with this decision an insurer would need to split the interest accreted on the residual margin between profit of loss and OCI.

18. There are two ways in which interest accreted on the residual margin could be split between profit or loss and OCI. Under the first approach, interest presented in profit or loss is accreted at the locked in rate whilst interest presented in OCI is calculated as equal to the difference between interest accreted at the current rate and interest accreted at the locked in rate. This is the simplest way of splitting the

amounts between OCI and profit or loss. However, the amounts presented in OCI have little meaning. This approach does not result in cost based information in the profit or loss and information about discount rate changes in OCI. The amounts presented in OCI reflect the mathematical results of accreting at two different discount rates.

19. In addition, under this approach the amounts recognised in OCI do not self-reverse. The example in Appendix A illustrates this. This is different to the effect of recognising discount rate changes on the liability cash flows in OCI. At the time when the liability is settled, the measurement of the liability will equal the actual cash paid and hence the effects of changes in discount rates presented in OCI self-reverse by that time. In contrast, the residual margin does not true-up to an actual cash-flow, hence the amounts in OCI do not self-reverse to zero. If interest accreted on the residual margin were split between profit or loss and OCI, the IASB would need to consider if the amount recognised in OCI should be recycled to profit or loss when the insurance liability is settled.

20. Another way of splitting the interest accreted on the residual margin between OCI and profit or loss would be to recognise a "catch-up" adjustment in OCI whenever discount rates change. This approach treats the residual margin as if it would result in a cash flow at some point in the future. Under this approach, the amounts recognised in OCI will self-reverse. However, it is more complex and the staff does not think that it necessarily results in better information for users.

21. Alternatively, the IASB could decide to require insurers to present interest accreted on the residual margin at the current rate in profit or loss (rather than splitting the interest between OCI and profit or loss). Presenting interest accretion at a current rate avoids the problems associated with recognising amounts in OCI that do not reverse to profit or loss and is simpler to apply. Splitting the effects of discount rate changes between OCI and profit or loss requires the insurer to track discount rates for groups of contracts. Presenting interest accretion at a current rate in profit or loss avoids these tracking issues. However, the staff does not recommend this alternative because it is inconsistent with the decision to split the presentation of interest on the cash flows between OCI and profit or loss. In

addition, interest presented in profit or loss in respect of insurance contracts would be a mixture of locked-in and current rates that may be difficult to explain.

Locked-in rate

22. The staff recommends that an insurer should accrete interest on the residual margin using the rate determined at inception (a locked-in rate).

23. Staff thinks that an insurer should accrete interest using the locked-in rate because:

    (a) An insurer determines the residual margin upon entering into the contract by taking into account the time value of money. Subsequently, as discussed in paragraph 15, an insurer can unlock the residual margin *only* for changes in estimates of future expected cash flows. However, the insurer would not unlock the residual margin for changes in discount rates. By not unlocking the residual margin for changes in discount rate, the residual margin implicitly reflects time value as estimated on day one. Locking the rate used to accrete the margin would be consistent with that view.

    (b) Using a locked-in discount rate avoids some of the problems associated with using a current rate, discussed in paragraphs 18-21. For example, the problems associated with recognising amounts in OCI that do not reverse to zero do not arise.

    (c) It treats the residual margin similar to a pre-payment in the ED proposals of *Revenue from Contracts with Customers*. In accordance with the proposals, an entity would accrete interest using the rate at the inception of the contract.

24. When determining which rate to apply, the staff considered the complexity associated with each alternative. Using a locked-in rate may be more complex for preparers than using a current rate as they would be required to track the locked-in rate for different contracts. However, the staff note that in March 2012, the IASB decided not to prescribe the unit of account used to release the residual margin.

The IASB decided that the release of the residual margin should be performed in a manner consistent with the objective of releasing the residual margin over the coverage period to the period(s) in which the service is provided. In order to achieve this objective, insurers may have to track and release the residual margin at a fairly granular level (probably lower than portfolio level). If insurers are tracking the residual margin at a fairly granular level, then tracking locked in rates at this level may not significantly increase complexity.

Question 1 – Rate of accretion on the residual margin
Does the IASB agree that an insurer should accrete interest on the residual margin using the discount rate of the liability determined at initial recognition, ie a locked-in rate?

Estimating the discount rate

25. Regardless of whether a current or locked-in rate is used to accrete the margin, some respondents have requested that the IASB provide additional guidance on determining the discount rate. As discussed in paragraph 10, the residual margin represents a blend of cash flows. Respondents were unsure of whether to use a single blended rate or whether an insurer should project the release of the margin and use a yield curve to determine the appropriate discount rate.

26. There are a number of different ways in which the accretion rate could be determined. Appendix B discuses two possible approaches.

27. However, the staff believes that it would be overly prescriptive to provide guidance on the accretion rate for the residual margin. The IASB has previously decided not to prescribe a method for determining the discount rate for the insurance liability. Instead the IASB has clarified the overall objective of the discount rate. Because the discount rate for accreting the margin is the discount rate for the cash flows, staff do not think further guidance is needed.

Question 2 – Estimating the discount rate

Does the IASB agree that additional guidance should not be provided on estimating the discount rate for the accretion of interest on the residual margin?

Appendix A – Example illustrating accretion of interest at current rate and presenting changes in discount rate in OCI as discussed in paragraphs 16-18

A1. The example below illustrates how the accretion of interest on the residual margin using a current rate could impact the profit or loss and other comprehensive income of an insurer. The simplified assumptions are:

(a) no change in assumptions, except for changes in discount rates;

(b) the entity expects to provide almost all of the services in year 2 (for simplicity release entire residual in year 2)

(c) the expected cash flows and discount rates are as follows:

Expected cash flow projections	**Y0**	**Y1**	**Y2**	**Y3**
Expected inflows (upfront premium)	3000			
Expected outflows (Claim incurred at end of Y2 and paid at end of Y3)		0	0	2800
Applicable rate of discount at the end of each period (assume a flat yield curve in each case)	5%	10%	7.5%	7.5%

A2. The insurer measures the insurance contract liability on inception as follows:

Expected inflows – upfront premium [A]	3 000
Expected outflows (PV discounted at 5%) [B]	(2 419)
Residual margin – eliminates gain on day 1 [A – B]	(581)

A3. The extract from the Statement of Comprehensive Income below shows how an insurer would present the effects of accretion on the residual margin. The table illustrates the net effects in the statement of comprehensive income of accreting interest on the residual margin, presenting interest expense in profit or loss estimated using the locked-in rate, with the effects of discount rate changes in OCI. This follows the arguments as stated in paragraph 18. As mentioned in paragraph 18, note that the amounts recognised in OCI does not self-reverse:

	Y1	**Y2**	**Y3**	**Total**
Extract of profit or loss statement				
Interest expense for accreting the margin presented using the locked-in rate (@ 5%)	(29)	(31)	0	(60)
Release of the residual margin	0	671	0	671
Net impact in profit or loss	(29)	640	0	611
Extract of other comprehensive income				
Effects of changes in discount rate on residual margin/ Net impact in OCI		(30)		(30)
Net impact in SCI	(29)	(610)	0	581

Appendix B – Two possible approaches to estimate the discount rate

B1 The appendix explains two methods insurers may use to estimate the discount rate to apply as discussed in paragraphs 25 - 27 to take into account period over which the residual is released. The staff acknowledges that there may be other appropriate methods.

B2 One method is to determine the discount rate based on the allocation pattern of the residual margin. This would require the insurer to allocate the residual margin into time buckets and then apply the appropriate discount rate to each bucket to determine the amount to be accreted. A simplified example illustrates this below.

> **Example 1**
>
> On day 1, the total residual margin is estimated to be CU 100 and will be allocated evenly in Year 1 and Year 2 (ie CU 50 each year). Assume no changes in assumptions and the discount rate for the liability's cash flows is 2% for cash flows in Y1 and 2.5% for cash flows in Y2. At the end of Year 1, CU 50 is accreted using the discount rate for cash flows in Year 1, ie 2%, and CU 50 is accreted using the discount rate of 2.5% for cash flows in Year 2.

B3 By applying the appropriate discount rate to the estimated allocation pattern of the residual margin, this method treats the amounts of the residual margin recognised in profit or loss consistently with the cash flows of the other components of the liability.

B4 Under the second approach, an insurer would apply an average discount rate that would reflect the various discount rates applied to the cash flows in measuring the insurance liability. This method will achieve the same objective as the first method, but with reduced effort to determine the rate. Using the same facts and circumstances as example 1 above, the simplified method could be applied as follows:

> **Example 2**
>
> Using the same facts as Example 1, the average discount rate is estimated to be 2.25% [(2%+2.5%)/2=2.25%)]. At the end of YR1, 2.25% is used to accrete the accumulated residual margin of CU100.

B5 The two alternatives provide similar results.