

STAFF PAPER

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Project	Insurance contracts		
Paper topic	The identification of underlying items		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

1. This paper continues the IASB's discussions of the adaptations that might be needed for contracts with participating features. For context, the staff suggest that the members refer to the papers for the May 2014 education session, namely:
 - (a) Agenda Paper 2A *Contracts with participating features: Background*, which provides background about contracts with participating features; and
 - (b) Agenda Paper 2B *Possible adaptations for participating contracts*, which provides an overview of the issues that the staff intend to consider relating to contracts with participating features.
2. In addition, Appendix B of Agenda Paper 2 *Cover note* for this meeting describes the IASB's model for contracts with no participating features, and how those proposals would be applied to contracts with participating features.
3. At the May 2014 education session, the staff described two proposed adaptations that would result in an entity accounting for insurance contracts in a way that would rely on the identification of underlying items. Those proposals are:
 - (a) that an entity should adjust the contractual service margin for changes in the insurer's share of the underlying items; and
 - (b) that an entity should apply a book yield approach to determine the amounts recognised in profit or loss and other comprehensive income.

4. At the May 2014 education session, IASB members expressed different views on the conceptual merits of the proposals. Some IASB members supported the proposals in paragraph 3, provided that the staff could find an appropriate way to identify the objectives of the proposals and to restrict the scope of the proposals to those contracts for which the proposals would meet the IASB's objectives. Others did not support the proposals, or believed that it would not be feasible to distinguish in a robust way the situations for which the proposals would be appropriate from those for which the proposals would not be appropriate.
5. Accordingly, the objective of this paper is to discuss the circumstances, if any, in which it would be appropriate for an entity to account for an insurance contract in a way that would rely on the identification of the underlying items. This paper does not reach conclusions about whether the adaptations described in paragraph 3 should be made if appropriate circumstances could be identified. Consequently, although this paper asks the IASB for tentative decisions for the purpose of directing the staff's future work, the staff plan to ask the IASB to confirm the decisions relating to contracts with participating features as a whole at a future meeting.
6. This paper does not consider whether any form of the mirroring exception proposed in the 2013 Exposure Draft *Insurance Contracts* (2013 ED) is needed. The mirroring exception applied only to the subset of contracts with participating features for which there could be no possibility of an economic mismatches between the returns on underlying items and payments to the policyholder. The staff plan to consider the need for (and any adaptations to) the mirroring approach in a future meeting.

Staff recommendations

7. The staff will ask the IASB to confirm all tentative decisions taken at this meeting when considering all the decisions relating to contracts with participating features as a whole.
8. If the IASB were to require an entity to adjust the contractual service margin for the insurer's share of the underlying items on the grounds that the insurer's share

represents an implicit management fee, the staff recommends that an implicit asset management fee should be considered to exist only when:

- (a) the returns to be passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items or whether the entity has discretion over the payments to policyholders). This is discussed in paragraphs 30-33;
- (b) there is a minimum amount (either fixed or determinable) that the entity must retain. This is discussed in paragraphs 34-36; and
- (c) the policyholder will receive a substantial share of the total return on underlying items. This is discussed in paragraphs 43-44.

9. If the IASB were to require an entity to apply the book yield approach for determining the interest expense presented in profit or loss, the staff recommend that the book yield approach should be applied only when:

- (a) the returns to be passed to the policyholder arise from the underlying items that the entity holds (regardless of whether the entity is required to hold those items); and
- (b) the policyholder will receive a substantial share of the total return on underlying items.

This is discussed in paragraphs 67-68.

10. In addition, the staff ask board members for their views on the amount that would adjust the contractual service margin (paragraphs 49-54) and on the mechanics of the book yield approach (paragraphs 55-65 and appendix A).

Overview of the paper

- 11. Paragraphs 14-17 discuss the relevant feedback received on the 2013 ED when considering developing specified requirements for contracts based on underlying items.
- 12. Paragraphs 18-54 discuss considerations related to adjusting the contractual service margin for changes in the insurer's share of the underlying items, in particular:

- (a) a reminder of the previous discussion viewing the insurer's share of underlying items as an implicit asset management fee (paragraphs 18-26);
 - (b) features of the link between cash flows to policyholders and underlying items that are relevant to determining any implicit asset management fee (paragraphs 28-48); and
 - (c) what amounts should adjust the margin if the IASB were to decide that the insurers' share of underlying items is equivalent to an implicit asset management fee (paragraphs 49-54).
13. Paragraphs 55-69 discuss considerations related to using the book yield to determine the amounts reported in profit or loss and other comprehensive income, in particular:
- (a) a reminder of the 2013 Exposure Draft *Insurance Contracts* (2013 ED) proposals and the feedback received in paragraphs 58-60;
 - (b) a summary of the book yield approach in paragraphs 61-65; and
 - (c) how the IASB might specify criteria for presenting interest expense in profit or loss based on the book yield approach, if the IASB were to decide that useful financial information would be provided by applying the book yield approach to determining interest expense in paragraphs 66-69.

Relevant feedback received on the 2013 ED

14. The feedback to the 2013 ED did not directly discuss how the IASB should specify the circumstances in which it would be appropriate for an entity to account for an insurance contract in a way that relies on the identification of the underlying items. However, the feedback on the proposals for the mirroring approach¹ and the recognition of the effect of changes in discount rate in other

¹ The mirroring exception is an exception to the general model in which the entity would measure the cash flows that depend on underlying items on the same basis as is used for the measurement of the underlying items.

comprehensive income (OCI) provide insight into the factors that need to be considered in specifying which contracts should be considered as depending on underlying items. This feedback is described in the following paragraphs.

15. Many disagreed with the scope of the mirroring exception, but for differing reasons:
 - (a) Many stated that it would be preferable not to have an exception, but that the same principles should apply to all insurance contracts. This view was echoed by the Accounting Standards Advisory Forum (ASAF) at its meeting in June 2014.
 - (b) Some would have restricted the scope of the mirroring exception further than proposed in the 2013 ED, by restricting it to situations in which there was also a contractual link to specified amounts paid to the policyholder. They held this view because they thought that the proposals were too difficult to apply to contracts in which there are discretionary payments.
 - (c) Some believed that a separate model for contracts with participating features was warranted, and that the separate model should encompass all contracts with participating features regardless of whether the entity is required to hold specified assets or the amounts returned to the policyholder contain some, or full, discretion. However, they did not necessarily agree that the mirroring exception was the right approach.
16. This paper does not discuss the mirroring exception. The IASB also received feedback on the relationship between the underlying items and insurance contracts as part of the feedback on the proposal of whether to recognise the effects of discount rate changes in OCI. That feedback indicated that for some contracts, the underlying assets are not specifically designated to portfolios, but are held in case the assets that are designated to a specific portfolio are insufficient to pay the policyholder's claims and benefits. Consequently, some think it is inherently arbitrary to designate assets to a specific portfolio unless the contract promises the policyholder *only* the performance of the specific assets in all scenarios (ie there are no options and guarantees). These contracts are not likely to exist in the population of the existing insurance contracts.

17. The difficulty in specifying the underlying items was one of the considerations behind the staff recommendation for an accounting policy option for presenting the effects of discount rate changes in either profit or loss or other comprehensive income. The staff concluded that it would not be feasible to specify criteria for assets backing the portfolio of contracts that could be used to distinguish which contracts should be accounted for through profit or loss, and which through OCI.

When can the insurer's share be considered to be a 'fee' for the asset management services provided?

18. There are different sources of income (and thus profit) that arise when an entity issues a contract with a participating feature. These include:
- (a) explicit fees that are deducted from an explicit account balance. Such fees could be of fixed amounts, or be determined using a formula based on the total fund balance or account balance; and
 - (b) a share of the returns of the underlying items, which is the difference between the returns that are earned on the underlying items and the share of those returns that are passed to the policyholder.²
19. Under IFRS, different sources of income are recognised in the financial statements in different ways. For example:
- (a) Asset management services fees are earned by providing asset management services. When an entity manages assets, it generally does not own/control the assets, and so the assets and the corresponding liabilities are not recognised on the balance sheet of the asset managers.
 - (b) Income earned as a 'spread' between an entity's own assets and liabilities on the balance sheet is not treated as a fee under the revenue recognition requirements. The 'spread' is recognised as the entity applies the separate requirements for the accounting for the assets and liabilities.

² The staff note that this may also be a source of profit for contracts with no participating features. For contracts with no participating features, no returns are passed to the policyholder.

20. In many contracts with participating features, a significant source of income for the insurer is the share of returns on underlying items that the insurer retains, instead of passing it on to policyholders. In the May 2014 education session, the staff explained two views of the insurer's share of the returns on underlying items:
- (a) Some regard the insurer's share of the returns on underlying items as akin to an implicit asset management fee. They view the insurer's share of the underlying items as economically equivalent to an explicit asset management fee that is based on the performance of underlying items.
 - (b) Others regard the insurer's share of the returns on underlying items as the insurer's economic interest in the underlying items. They view the insurer's investment return on the underlying items in one of two ways:
 - (i) as equivalent to an investment return that a non-insurer might make on prepaid consideration; or
 - (ii) as equivalent to the 'spread' between the entity's assets and its obligations to the policyholders.
21. At the May 2014 education session, some IASB members indicated that they had a degree of sympathy for viewing at least part of the insurer's income as an implicit management fee, and asked the staff to explore the view that an asset management fee arises for the service provided to the policyholder in managing the policyholder's share of the underlying items. However, those members also acknowledged that some of the profit earned by the entity seemed to result from an ownership interest in the underlying items, ie through the spread between the assets and liabilities. Because the accounting outcomes between these two positions are significantly different, it is important to clearly distinguish when each view applies.

Implications of how the insurer's share is viewed

22. The model proposed by the IASB would result in changes in **estimates relating to future services** of the contract being treated similarly to how they would be treated applying the revenue recognition requirements. To achieve this, changes in estimates relating to future services would adjust the contractual service margin and be recognised in profit or loss over the coverage period of the contract. Thus,

if the IASB were to regard the insurer's share of underlying items as a fee for asset management services, changes in estimates of the insurer's share of underlying items would adjust the contractual service margin and be recognised in profit or loss over the coverage period.

23. In contrast, the model proposed by the IASB would result in changes in **estimates that do not relate to service** being treated similarly to how they would be treated if the financial instruments requirements were being applied to changes in the value of assets and liabilities measured at fair value. This would mean that the changes in estimates would be recognised in profit or loss in the period of change. If the IASB were to regard the insurer's share of underlying items as a change in the insurer's economic interest in the underlying items, change in estimates of that economic interest would be recognised immediately in profit or loss.
24. However, in the staff's view, adjusting the contractual service margin for changes in estimates of the insurer's share of underlying items would go beyond the proposals in the 2013 ED for adjusting the contractual service margin for changes in estimates relating to future service. (Such include changes of estimates of explicit management fees that are part of the cash flows of the insurance contract.) This is because:
- (a) when the margin is adjusted for changes in estimates of **explicit fees**, the corresponding adjustment is recognised in the fulfilment cash flows of the liability. Consequently:
 - (i) the total insurance liability is the same before and after the adjustment; and
 - (ii) There is no effect on the profit or loss in the period as a result of the adjustment, only an effect on the amounts of the margin allocated to profit or loss in future periods.
 - (b) When the margin is adjusted for changes in estimates in the **insurer's share of the underlying items**, the corresponding adjustment is recognised in the statement of comprehensive income. Consequently:
 - (i) there is a change in the amount of the total insurance liability after the adjustment; and

- (ii) there is a corresponding change in the statement of comprehensive income.

25. In the staff's view, only the adjustment in paragraph 24(a) is consistent with the approach used in IFRS 15.
26. In addition, the staff observe that, under the IASB's model, the cash flows relating to the insurer's share of the underlying items are not part of the fulfilment cash flows of the contract, because they arise from the underlying items and not from the rights and obligations of the contract to the policyholder. In other words, these cash flows were never unbundled/separated from the contract because they were never part of the contract's cash flows in the first place.
27. Consequently, the staff view the issue of whether to include changes in estimates of insurer's share of the underlying items as an adjustment to the contractual service margin as being a question of whether these additional cash flows should be combined with the fulfilment cash flows already present in the contract. This is similar to the question of when it is appropriate to combine two or more contracts to be accounted for as a single contract. However, the contract combination guidance in the 2013 ED proposals applies to the combining of two or more insurance contracts and with the same or related counterparties. That contract combination guidance would not combine the cash flows from the underlying items with the cash flows of the insurance contract.

Features of the link between cash flows to policyholders and underlying items—implicit asset management fee

28. This section discusses the following criteria, which are based on the relationship between the underlying items and the insurance contract liability in considering when there is an implicit asset management fee:
 - (a) whether the entity is required to hold the underlying items. This is discussed in paragraphs 30-33.
 - (b) the role of discretion that the entity has over the amounts of the returns from underlying items that are passed to the policyholder. This is discussed in paragraphs 34-36.

- (c) the nature of the insurer's share of the underlying items. This is discussed in paragraphs 37-39.
 - (d) how much of the returns of the underlying items that the entity would pass to the policyholders, ie the extent of participation. This is discussed in paragraphs 43-44.
29. For simplicity, the analysis considers the relationship between the underlying items and the insurance liability, in the absence of options and guarantees that may reduce the investment risk for the policyholder (eg in the absence of a minimum return guarantee).

Holding the underlying items

30. Insurance contracts that provide policyholders with returns based on underlying items may have differences in whether the entity is required to hold the underlying items:
- (a) In some cases, the contract or local regulations require the entity to hold and segregate the underlying items separately from the rest of the entity's assets and liabilities. When this is the case, there may be differences in how such segregated underlying items are treated on liquidation:
 - (i) In some jurisdictions the underlying items remain segregated from the rest of the entity's assets and liabilities on liquidation and are not subject to the insurer's default risk. Those underlying items can be used to only pay the insurer's obligations arising from the specified contracts with participating features.
 - (ii) In other jurisdictions, while the underlying items must be held separately from the rest of the entity's assets and liabilities, those items may be treated like any other of the entity's assets and liabilities if the entity were to be liquidated.
 - (b) In other cases, there may be no explicit requirements for the entity to hold and segregate the underlying items, as described in paragraph 30(a). However:

- (i) there may be regulatory incentives to hold the underlying items for which the entity shares the returns with the policyholder;
- (ii) the entity may choose to designate the underlying items to specified insurance contracts portfolios as part of its internal management practices. This could create the following difficulties:
 - 1. the entity may change those designations, eg for various business reasons.
 - 2. the underlying items may not be clearly identified for a specific portfolio because the entity may have several portfolios that relate to the same underlying items.
- (iii) the entity could promise a return based on a specific type of underlying items and could choose to invest the premiums in different underlying items. For example, an entity could promise a return based on the performance of a share index and choose to invest the premiums in a combination of bonds and derivatives. It is unclear whether there is an implicit asset management fee in such a case.
- (iv) there may be no assets designated even though the policyholder could be provided with an interest-like return in the form of a crediting rate. The crediting rate would generally reflect the entity's overall performance and expectations. However, it is unclear whether there is an implicit asset management fee.

31. Some distinguish between contracts by which the insurer is required to hold the underlying items (ie as described in paragraph 30(a)) from those by which the insurer may choose, but is not required, to hold the underlying items (ie as described in paragraph 30(b)). They think that a requirement to hold the underlying items is more analogous to the situation in which an asset manager is managing the customer's assets on their behalf. Hence they think that, an implicit fee may exist only in those situations.

32. Others think that a more meaningful distinction would be whether or not the entity holds the underlying items, regardless of whether the insurer is *required* to hold the underlying items. They think that the most important feature is that the entity shares returns on underlying items that the entity holds, regardless of the reasons that the entity holds the underlying items. However, some see a distinction between:
- (a) contracts by which the amounts ultimately passed to policyholders are affected by changes in the returns on the underlying items held. In such cases the policyholder is affected by the returns generated by the entity in managing the underlying items; and
 - (b) contracts by which the policyholder is promised a return based on the performance of a notional pool of underlying items (eg an index) and the entity then chooses to purchase the same pool of underlying items. This is because the entity's success or failure in managing those underlying items has no effect on the performance of the notional pool of underlying items, and no effect on the amounts that are ultimately passed to the policyholder.
33. In the staff's view, only the contracts described in paragraph (a) provide asset management services and they provide those services regardless of whether the entity is required to hold the assets.

Role of discretion

34. Assuming that there is a contractual/regulatory link between the portfolios of contracts with participating features with a pool of underlying items, there are differences in the extent to which the entity has discretion over how to share the returns of the underlying items:
- (a) For some contracts, there are requirements in the contract or regulation that determine the amounts of, and the timing of when, the returns in the underlying items shared with the policyholder. For example, in many unit-linked or index-linked contracts, the entity shares immediately with the policyholder a fixed proportion of the returns on underlying items.

- (b) For other contracts, the entity has full discretion over the amount of returns from underlying items that are shared. In those cases, the amount that is shared is nonetheless affected by factors such as:
 - (i) competitive pressure, including from other insurance contracts, and from non-insurance investment products; and
 - (ii) regulatory pressure. Regulators are typically concerned with the solvency of the entity and/or fairness to the policyholder. They may have a view on the appropriateness of amounts shared, taking into consideration the performance of the underlying items held by the entity.
- (c) There are many contracts that are in between the two extremes in (a) and (b). This may be the case when the contract/regulation defines a minimum that must be shared to the policyholder but the entity has discretion to pay amounts above that minimum. It can be difficult to identify when cash flows reflect a share of underlying items, rather than a payment made at the entity's discretion that does not reflect a share of the underlying items.

35. In the staff's view, the presence of discretion should affect the conclusion about whether an entity has earned a fee from its share of the underlying items. This is because a characteristic of a fee is that it is subject to the contractual terms between the customer and the entity. This is the case even when fees are variable, because the formulas for the amount of those variable fees are fixed in the contractual terms. When the entity has discretion over how much of the returns of the underlying items are shared between the policyholder and insurer, the entity's share of the returns becomes akin to an ownership (or residual) interest or financial return.

36. The staff's view is illustrated as follows:

- (a) If the entity is required by regulation to share exactly X% the returns with the policyholder, then 100-X% behaves economically similarly to a fee arrangement, because the fee arrangement percentages are fixed at inception.

- (b) If the entity is required to share at least A% of the returns with the policyholder and the entity has discretion to share up to and including an additional B% of the returns with the policyholder, the insurer's share of the underlying items that is not subject to discretion is C% which equals $100\% - A\% - B\%$. The C% is not subject to discretion (ie it is the amount that the insurer is certain to receive). That amount behaves in an economically similar way to a fee arrangement.
- (c) If the entity has discretion to set the share the returns to be paid to the policyholder, with no contractual or regulatory restraints on the percentages that it need not share with the policyholder, this behaves economically like an ownership interest in the underlying items. The presence of discretion means that it is the entity's choice whether to share or retain the returns on the underlying items, which is different to a fee that is determined at inception of the contract.

Nature of the insurer's share

37. The question that arises is whether there is any substantive economic difference between the different sources of income, and whether all income earned by the insurer can be considered economically to be equivalent to a 'fee' for the asset management services provided. In other words, is there is an economic difference between different sources of income, depending on whether the income is determined:
- (a) as a fixed amount or amounts without any reference to the underlying items;
 - (b) as a function of both the amounts invested and any returns on those invested amounts; or
 - (c) as a function of only the returns arising from the underlying items?
38. Some distinguish the income in 37(a) and 37(b) (which they consider to be a fee for asset management services provided) from the income in paragraph 37(c) (which they consider to be income from taking risk). This is because the insurer would make no income if the returns are nil in a period, even though the insurer has performed asset management services. Those with this view believe that a fee

would result in income for the insurer regardless of the returns on the underlying items.

39. Some might argue that earning income regardless of the returns on underlying items is not a necessary condition for a fee. For example, a hedge fund manager could charge a per annum asset management fee of 2% of the total balance of the fund and 20% of the excess of the total fund over a set amount on maturity. Both of those contributions to income (ie the 2% and the 20%) would be accounted for under the revenue recognition proposals as fees for the provision of asset management services, even though only the 2% would result in income for the insurer regardless of the returns on the underlying items.
40. Some think that an arrangement in which the entity owns the assets and passes on a share of the returns on the assets (such as in an insurance contract) is different from an arrangement in which the entity does not own or control the investments but nonetheless earns income from managing the investments (such as in a hedge fund). Those with this view note that under other IFRSs, an entity would not earn an asset management fee for managing investments it controls, regardless of how it uses the return on those investments.
41. At the May 2014 education session, some IASB members acknowledged that these distinctions exist in other IFRSs. However they questioned whether such distinctions should apply for insurance contracts, because the IASB has already decided to develop a separate model for insurance contracts. In particular, some suggested that a distinguishing feature of insurance contracts could be that the entity earns a fee on assets that it recognises on its balance sheet because, although the entity controls the assets, those assets are in effect held on behalf of the policyholder.
42. Furthermore, the staff observe that if the IASB were to decide:
- (a) that fees exist only if the entity does not own the assets, or
 - (b) that fees only exist when the income is determined as a fixed amount, amounts without any reference to the underlying items, or as a function of both the amounts invested and any returns on those invested amounts:

then it is likely that very few contracts with participating features will qualify.

43. The staff plan to revisit this discussion when the IASB discusses whether to adjust the margin for the insurer's share of underlying items. However, if the IASB decides to adjust the margin for the insurer's share of the underlying items, then the staff believe that restricting the circumstances to which that decision would apply to would be counterproductive. Accordingly, the staff do not propose to specify criterion based on the nature of the insurer's share.

The extent of participation

44. Another factor that could be considered is the extent in which the returns on the underlying items held by the entity are passed to the policyholder.

(a) For some contracts, substantially all the returns of the underlying items are passed to the policyholder.

(b) In other contracts, the returns of the underlying items that are passed to the policyholder are not substantially all of those returns. For example, this could occur when the linkage is at a higher level than the portfolio:

(i) It may be the case that the policyholder shares in the underlying items that are not allocated by law/regulation to other specific portfolio of contracts. These are often termed 'general account' items. (Sometimes policyholders also receive returns from the performance a portfolio, several or all portfolios of insurance contracts or from cost savings.)

(ii) There could be a pool of underlying items that is linked to several portfolios rather than a single portfolio of insurance contracts. This may occur when regulation or the internal management systems require segregation of the underlying items in a different way to the 2013 ED proposal of a portfolio of insurance contracts.

45. The staff believe that there is a difference in whether the policyholder shares substantially in the returns of the underlying items or not. When the policyholder does not share substantially in the returns of the underlying items, the entity retains a correspondingly bigger share, and some think that this bigger share is

more similar to a residual interest in the underlying items than to a fee for an asset management service. This is because when the entity, instead of the policyholder, retains a substantial share of the returns of the underlying items, the entity benefits more than the policyholder from how it manages the underlying items.

46. If the IASB agrees that this is a defining criterion, then the IASB will need to decide at a later stage whether to provide further guidance on this criterion.

Conclusion

47. Paragraphs 28-45 suggests that the following criteria indicate that an implicit asset management fee exists when:
- (a) the returns to be passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items) (in paragraphs 30-33;
 - (b) there is a minimum amount (either fixed or determinable) that the entity must retain (in paragraphs 34-36); and
 - (c) the policyholder will receive a substantial share of the total return on underlying items (in paragraphs 44-45).

Appendix B sets out the implications of the criteria for some contracts with participating features.

48. The staff note that these criteria would mean that some contracts with participating feature would not qualify for adjusting for the insurer's share. However, one scenario that would qualify for the presence of an implicit asset management fee is in the case that there are contracts with a unit-linked participating feature and the entity has a share of the underlying items because it owns some of the units in the fund. In this scenario, most do not think the entity's ownership of the some of the units in the fund is that there is an implicit asset management and the margin should be adjusted for changes in value of the entity's own units. Hence, if the IASB agrees with the criteria discussed in paragraph 47, it would need to consider whether to explicitly exclude this scenario (and why).

Question 1—insurer's share of underlying items

If the IASB were to require an entity to adjust the contractual service margin for the insurer's share of the underlying items on the grounds that the insurer's share represents an implicit asset management fee, does the IASB agree that an implicit asset management fee should be considered to exist only when:

- (a) the returns to be passed to the policyholder arise from the underlying items the entity holds (regardless of whether the entity is required to hold those items);
- (b) there is a minimum amount (either fixed or determinable) that the entity must retain; and
- (c) the policyholder will receive a substantial share of the total return on underlying items?

What amounts should adjust the margin?

49. If the IASB were to decide that the margin should be adjusted for changes in the insurer's share of underlying items as described in Question 1, there are differing views on the amount of the adjustment to the contractual service margin:
- (a) Some propose that the margin should be adjusted by the change in estimate of the insurer's share of underlying items, measured consistently with the measurement of the fulfilment cash flows. This approach would measure the liability and its components consistently.
 - (b) Some propose that the margin should be adjusted by the change in estimate of the insurer's share of underlying items, determined on a basis that reflects the effect of the equivalent changes in estimates of the underlying items in profit or loss. This means that those changes could be a mixture of changes in the underlying items at cost, or at current value, depending on how those items are accounted for under IFRS. Some think this approach could avoid adjustments to the margin that might eliminate the margin too quickly. They also think adjusting the margin by the estimates of returns of the underlying items recognised only in profit or loss provides a better representation of the implicit asset management fee. However, this approach is subject to the same

criticisms of the mirroring approach, ie that requiring a component of the liability to be measured as a combination of different accounting bases would not provide a faithful representation of the contract and might not be understandable to users.³

- (c) Some propose that the margin should be adjusted by the stand-alone selling price of the asset management service. This is discussed further in paragraphs 50-54.

Stand-alone selling price

50. At the May 2014 education session, some IASB members asked the staff to explore whether the stand-alone selling price for a asset management fee could be identified. In the staff's view, to identify a stand-alone selling price for the implicit management fee, the entity would need to:

- (a) identify what a market participant would charge for managing similar or identical underlying items for which the returns are passed to the policyholder (ie the stand-alone selling price);
- (b) on initial recognition, identify as a portion of the margin an implicit asset management fee based on the stand-alone selling price less any explicit fees⁴ that the entity charges. That portion would be recognised over the life of the insurance contract; and
- (c) on subsequent measurement, remeasure that portion to take into account any appropriate subsequent changes in estimates and allocate the margin to profit or loss.

51. Another issue that the IASB would need to consider is whether the entity would need to reassess the steps in paragraph 50 at the end of each reporting period, to

³ For example, the contract shares 90% of the returns of the underlying items with the policyholder. 50% of the underlying items are measured at cost and 50% at fair value.

Under the mirroring approach, the fulfilment cash flows would be equal to 90% of (50% of underlying items measured at cost + 50% of the underlying items measured at fair value on the balance sheet).

Under this alternative approach, the margin would be equal to 10% of (50% of returns of the underlying items measured at cost + 50% of returns of the underlying items at fair value, expected over the life of the contract).

⁴ The staff note that in some cases, there would be explicit fees charged, as well as implicit fees recovered in the form of the insurer's share of the underlying items.

reflect any changes in stand-alone selling price that result from changes in what market participants would charge.

52. For example, assume other asset managers are charging 1.5% of the total balance per annum of the net assets under management for assets with similar characteristics to the underlying items. The insurer would need to determine:
- (a) on Day 1, the portion of the margin equal to 1.5% of the total balance per annum of the underlying items over the expected life of the contract; and
 - (b) subsequently, that portion of the margin would need to be remeasured for any changes in the estimates of the underlying items related to the future and changes in the expected life of the contract.
53. If the market changed in such a way that that asset managers in a subsequent period would charge only 1% of the total balance per annum of the net assets under management, that change in standalone selling price would also need to be reflected in the measurement of the margin.
54. The staff plan to assess the feasibility of identifying a standalone selling price for the implicit management fee at a future meeting.

Question 2—What should adjust the contractual service margin?

Do IASB members have questions or comments on the amount that would adjust the contractual service margin, if the IASB were to agree in principle that the contractual service margin should be adjusted by changes in estimates of the insurer's share of underlying items?

Book yield

55. This section explores the identification of the underlying items that would be needed if the IASB were to conclude:
- (a) that there are circumstances in which the effects of changes in discount rate could appropriately be recognised in OCI for contracts with participating features; and

- (b) that the effects of changes in discount rates recognised in OCI would be determined using the book yield approach.
56. Some think that different criteria could apply to the identification of underlying items for the book yield approach to those that may apply for the insurer's share of the underlying items. They argue that objectives for the book yield approach and for adjusting for the insurer's share of the underlying items are different and that there are different accounting consequences:
- (a) The book yield approach is a method for determining the presentation of changes in the liability in profit or loss and OCI. It does not affect measurement.
 - (b) Adjusting the margin for the insurer's share of the underlying items affects the measurement of the total liability and therefore equity.
57. The following paragraphs:
- (a) provide a summary of the relevant 2013 ED proposals in paragraphs 58-60;
 - (b) provide a summary of the book yield approach in paragraphs 61-65. Further details of the mechanics of the book yield approach are in Appendix A; and
 - (c) discuss the criteria for specifying when the book yield approach should be used, if the IASB decides to use the book yield approach in paragraphs 66-69.

2013 ED proposals

58. The 2013 ED proposed that the interest expense is calculated using a discount rate that is:
- (a) locked in at contract inception for cash flows that do not vary for underlying items; and
 - (b) reset every time there are changes in the amounts paid to policyholders that result from changes in estimates of returns from the underlying items. Those changes in estimates of investment returns are generally

caused by changes in market variables, which is also reflected in the current discount rates.

59. Using the locked-in rate that is reset for cash flows that vary with underlying items is consistent with:
- (a) the fact that at the contract inception the insurer has promised the policyholder a variable return; and
 - (b) the accounting for floating rate debt instruments not marked to market through profit and loss (for example, at FVOCI), for which the locked-in discount rate used to present interest expense is reset upon changes in interest rates.
60. Many agree that the discount rate for determining the interest expense for insurance contracts should be reset if the entity applies an accounting policy choice to recognise amounts in OCI. However:
- (a) many would reset the discount rate for *all* the cash flows for contracts with participating features, rather than only for cash flows that vary directly with returns on underlying items. Contracts with participating features contain a mixture of types of cash flows that vary and do not vary directly with underlying items, and in different proportions that may change over time.
 - (b) Some would reset the discount rate to a different discount rate. The book yield approach is one of two approaches suggested. This paper only discusses the book yield approach, because this approach relies on the identification of the underlying items. We intend to discuss other alternatives for the mechanics of the OCI approach in a future meeting.

What is the book yield approach?

61. The book yield approach would determine the discount rates used to recognise the unwind of the discount rate in profit or loss and the amounts in OCI. It does not affect the measurement of the insurance contract liability. Those that propose this approach would apply those discount rates to all the cash flows of the contract in order to determine the interest expense that would be reported in profit or loss. As

a result, one feature of the book yield approach is that it could reduce the accounting mismatches between the interest expense reported on the insurance contracts and the equivalent interest income on the underlying items.

62. The book yield approach derives the discount rate for the presentation of the interest expense from how the underlying items are treated under IFRS (ie market yield for assets held at FVPL and an amortised cost-based yield for assets held at amortised cost or FVOCI). Thus, to apply the book yield approach, the book yield curve has to be constructed at the end of each reporting date, based:
- (a) on the underlying items held at that date and how those items are accounted for under IFRS for each current and future years until the time when the item is expected to be sold or derecognised; and
 - (b) for the periods after the item is sold or derecognised, the future reinvestment assumptions based on the market information at the date.

The following example illustrates this.

Example 1: Constructing a yield curve using the book yield approach

Assume that the duration of the liability is expected to be 30 years. At the end of the reporting period, the underlying items are bonds (accounted for at FVOCI), which the entity expects to hold until Year 10. A yield curve would have to be constructed up to and including Year 30.

Under the book yield approach:

- (a) Year 01-Year 10 uses the effective interest rate of the bonds;
- (b) Year 11- Year 30 uses an expected reinvestment rate. This rate is based on the current market conditions present at the reporting date and must be consistent with the assumptions used to project the cash flows. Feedback indicates that the difference between this rate and the rate used on the balance sheet is likely to be small. Consequently, the amounts recognised in OCI for this time period are likely to be small.

63. Appendix A provides more information on the mechanics of the book yield approach.
64. Some see the advantages of the book yield approach in addressing accounting mismatch because it avoids accounting mismatches in the following situations:

- (a) when the underlying items held are a combination of items accounted for at cost and items accounted for at fair value through profit or loss. This is because the book yield approach would reflect the effect of the combination of items.
- (b) when the underlying items are accounted for at cost and a gain or loss is recognised on its sale in profit or loss. This is because the book yield approach would result in a corresponding amount recognised in profit or loss for the liability.

Some note that the entity could address accounting mismatches in the same situations above by choosing to present the effects of discount rate changes for the liability in profit or loss and to elect to account for the underlying items at fair value through profit of loss (FVPL).

65. If the IASB were to conclude that there are circumstances in which the effects of changes in discount rate could appropriately be recognised in OCI using the book yield approach, the IASB would need to decide on some of the mechanics of the approach as discussed in Appendix A.

Question 3—Mechanics of the book yield approach

Do the IASB members have any questions or comments on the mechanics of the book yield approach described in paragraphs 61-65 and Appendix A?

Why do we need to specify when it would appropriate to use the book yield approach?

66. One feature of the book yield approach is that it could reduce the accounting mismatches between the interest expense reported on the insurance contracts and the equivalent interest income on the underlying items. This reduction of accounting mismatches may be appropriate when there is an economic match between the underlying items and insurance liability. An economic match is likely to occur when there is a clear relationship between the underlying items recognised on the balance sheet and the amounts passed on to the policyholder. However, this approach may not result in useful information when there is no clear relationship and therefore no economic match.

67. In determining when that clear relationship arises, the staff think the following considerations apply in specifying underlying items for the purpose of determining book yield:

(a) **Whether the entity is required to hold the underlying items.**

In the staff's view, an economic match can occur regardless of whether the insurer is *required* to hold the underlying items or the insurer *chooses* to hold the underlying items. In other words, staff believe an economically matched situation can occur in either of the following scenarios:

- (i) the entity holds underlying items and changes in the returns of those items will cause a change in the amounts finally passed to the policyholder; or
- (ii) the policyholder is promised a return based on the performance of notional pool of underlying items (eg an index) and the entity chooses to purchase and hold that pool of underlying items.

(b) **Whether the entity has discretion over the return to policyholders.**

The staff believe that it is *not* important whether the entity may have discretion in the amounts passed to the policyholder, because the staff think the other criteria discussed in paragraphs 67(a) and 67(c) is sufficient to capture the objective that the underlying items and the liability are substantially economically matched. The staff think that it does not matter why the underlying items and the liability are matched, only that they are.

(c) **Whether the policyholder receives a substantial share of the returns.**

In the staff's view, an economic match between the underlying items and the liability could occur even when the policyholder does *not* receive a substantial share of the returns. However, the staff are concerned that the costs would outweigh the benefits of the book yield approach when the policyholder does not receive a substantial share of the returns. The staff do not think that the book yield approach would lead to significant differences to the other alternatives for determining

the unwind of the discount rate in profit or loss and amounts in OCI.

Consequently, the staff think the book yield approach should be applied when the policyholder receives a substantial share of the returns of the underlying items held.

If the IASB agrees that this is a defining criterion, then the IASB will need to decide at a later stage whether to provide further guidance on this criterion.

68. In conclusion, the staff think that the book yield approach could be applied to insurance contracts in which the entity passes to policyholders a substantial share of the returns from underlying items the entity holds. This criterion is irrespective of:
- (a) whether the entity has discretion over the payments to policyholders; or
 - (b) whether the entity is required to hold the underlying items.
69. The staff think that the entity should determine whether the criterion in paragraph 68 are met at every reporting date by assessing whether facts and circumstances indicate that there is a change. For example, there may be instances in which the entity changes the designations of the underlying items in such a way that the total returns of the underlying items are no longer substantially passed to the policyholder. If this were the case, the staff think that the entity should no longer be permitted to use the book yield approach from the date of that change. The staff note that this means that the IASB would need to determine the mechanics of the OCI approach for contracts with participating features that would not meet the criteria discussed in paragraph 68, if the IASB were to conclude that there are circumstances in which the effects of changes in discount rate could appropriately be recognised in OCI using the book yield approach.

Question 4—When it is appropriate to apply the book yield approach?

If the IASB were to require an entity to apply the book yield approach for determining the interest expense presented in profit or loss, does the IASB agree that the book yield approach should be applied only when:

- (a) the returns to be passed to the policyholder arise from the

- underlying items that the entity holds (regardless of whether the entity is required to hold those items or whether the entity has discretion over the payments to policyholder); and
- (b) the policyholder will receive a substantial share of the total return on underlying items?

Appendix A: Book yield approach

A1. The following section discusses the mechanics of the approach as follows:

- (a) paragraph A2 describes how the book yield rate is determined from the way the underlying items are accounted for under IFRS; and
- (b) paragraphs A3-A6 discuss whether further adjustments are needed to the book yield rate determined in accordance with (a).

A2. The following table discusses how the book yield rate is determined from the way the underlying items are accounted for under IFRS.

Underlying item	How the book yield approach would determine the discount rate	Staff comments
<p>Underlying items accounted at fair value through profit or loss</p> <p>Examples of these underlying items are financial assets and financial liabilities measured at fair value and investment properties at fair value.</p>	<p>The discount rate would reflect the current yields of the underlying items.</p> <p>Some think that the current discount rates for the insurance liabilities (used for balance sheet measurement) may be a close enough approximation.</p>	<p>The current discount rate for the insurance liability may be a close enough approximation because the discount rate reflecting the characteristics of the liability would include the extent of the dependence on the underlying items, which is updated at every reporting period.</p>
<p>Underlying items accounted at cost in profit or loss</p>		
<p>Financial liabilities and assets accounted for at amortised cost and financial assets at FVOCI</p>	<p>Under the book yield approach, the effective interest rate of the bond is used as the discount rate for the liability to determine the unwind of the discount recognised in profit or loss.</p>	<p>The staff think that the book yield approach would reduce accounting mismatch for these underlying items.</p>

Underlying item	How the book yield approach would determine the discount rate	Staff comments
<p>Equity instruments at FVOCI</p>	<p>Those that propose that the book yield approach think that the discount rate for equity instruments held at FVOCI should either be:</p> <ul style="list-style-type: none"> (a) a discount rate reflecting the expected dividend stream (eg dividends divided by the fair value of equity instruments); or (b) a risk-free-rate, because some think it is too difficult to estimate the discount rate based on the expected dividend stream discussed in (a). 	<p>It is questionable how useful a risk-free rate would be for discounting cash flows arising from equity instruments for the recognition of changes in liability in profit or loss. The staff note that using a risk-free rate may create an accounting mismatch because a risk-free rate is unlikely to reflect the same characteristics as the dividends recognised.</p> <p>Moreover, the book yield approach is unlikely to be able to reduce accounting mismatch for equity instruments at FVOCI. This is because a policyholder that shares in the returns of equity instruments is likely either to share in the fair value gains and losses for these instruments, or the dividends and any gains on the sale of the instrument in excess of its purchase price. Under the book yield approach, a mismatch still arises because the amounts in OCI for the insurance liability self-reverses to zero and there is no recycling for the equity instruments. The staff note that the FVOCI option for equity instruments was intended for equity instruments held for strategic purposes.</p> <p>Consequently, addressing accounting mismatch for equity instruments would require the entity to apply FVPL.</p>

Underlying item	How the book yield approach would determine the discount rate	Staff comments
Investment property at cost	<p>For investment properties accounted for at cost, there are two alternatives:</p> <ol style="list-style-type: none"> 1. a discount rate that reflects the expected rent minus the expected defaults (eg rent received or expected to be received divided by the investment property recognised at cost on balance sheet); or 2. a risk-free rate, because they think that the discount rate that reflects the rental yield as too complicated. 	<p>Some think that the discount rate that reflects the rental yield would be too complicated to determine.</p> <p>However, it is questionable how useful a risk-free rate would be for discounting cash flows arising from the rental income for the recognition of changes in liability in profit or loss.</p> <p>Applying a risk-free rate may create an accounting mismatch, because a risk-free rate is unlikely to reflect the same characteristics of the rental income recognised</p>
Underlying item is a share of a business operations (eg a combination of an investment performance, mortality and cost savings)	<p>Has not yet been discussed with proponents of the book yield approach.</p>	<p>To be consistent with the principles of the book yield approach, the staff think that that the entity will need to compute the discount rate by considering the appropriate discount rate for all the underlying items. For example, the amount of net profit for the business operations divided by the net assets of the business operations for each year. Both the net profit and the net assets would be determined under IFRS.</p>

Further adjustments

- A3. The table in paragraph A2 discusses how the book yield approach determines the discount rate for the presentation of interest expense, by considering how the underlying items are accounted for under IFRS. As a second step, some suggest further adjustments are needed to determine the discount rate for interest expense as follows.

Avoiding amounts in OCI on Day 1

- A4. The table in paragraph A2 discusses how the book yield approach would determine the yield curve used to determine the unwind of the discount recognised in profit or loss. Those that propose the book yield approach recommend a practical expedient that, at inception of the contract, the yield curve for the presentation of the unwind of the discount that would be recognised in profit or loss is the same as the yield curve used for the measurement of the liability on the balance sheet. This practical expedient avoids the recognition of amounts in OCI on Day 1, which may occur if the yield curve is constructed using the book yield approach at that date.

Differences in the characteristics of the underlying items and the liabilities

- A5. Some would make further adjustments to take into account the differing characteristics of the underlying items and the liability. For example, if the policyholder does not share in the expected credit losses of a bond instrument, the fulfilment cash flows would reflect the interest income (and any other gains losses the policyholder shares in) minus expected credit losses. Consequently, some would also deduct the expected credit losses from the book yield discount rate for the presentation of interest expense. The staff note that this adjustment may not reduce accounting mismatch:
- (a) when the underlying items are bonds accounted for at amortised cost and FVOCI, because there is a difference, in some instances, in how expected credit losses are accounted between the bonds and the insurance liability; and

(b) when the underlying items are equity instruments and investment properties and accounted for at cost, there is a difference in how the expected defaults are accounted for between those underlying items and the insurance liability.

A6. Another example is where there are differences in liquidity between the underlying items and the insurance liability. Some would adjust the book yield discount rate to account for the difference in the liquidity characteristics.

Appendix B: Brief description of the application of the criteria

A7. The following table sets out examples of the application of the criteria to determine

- (a) when there is an implicit asset management fee as discussed in paragraph 47; and
- (b) when it is appropriate to use the book yield approach in paragraph 68.

Description of some types of participating contracts	When there is an implicit fee?				When it is appropriate to use book yield?		
	Underlying items held determine the returns to be passed to the policyholder (paragraphs 30-33)	Minimum amount that the entity must retain (paragraphs 34-36)	Entity receives a fixed amount or a percentage of both the underlying items and the returns ⁵ (paragraphs 37-39)	The policyholder will receive a substantial share of the total return on underlying items (paragraphs 44-45)	Policyholders receives the returns from the underlying items that the entity holds (paragraph 67(a))	The entity has no discretion over the returns to the policyholder (paragraph 67(b))	The policyholder receives a substantial share of the returns (paragraph 67(c))
Staff recommended criterion	Recommended	Recommended	Not recommended	Recommended	Recommended	Not recommended	Recommended
Discretionary 90/10 The policyholder is legally or contractually entitled to receive at least 90% of the (post-tax) statutory result of the business. The entity usually decides to pay more than the	Yes	Depends. Some contracts state that the policyholder can receive no	No. The insurer shares in the returns.	Yes	Yes	Discretion in timing and amount.	Yes

⁵ The staff does not propose that there should be a requirement based on whether the entity receives a fixed amount or a percentage of both the underlying items and the returns.

Description of some types of participating contracts	When there is an implicit fee?				When it is appropriate to use book yield?		
	Underlying items held determine the returns to be passed to the policyholder (paragraphs 30-33)	Minimum amount that the entity must retain (paragraphs 34-36)	Entity receives a fixed amount or a percentage of both the underlying items and the returns ⁵ (paragraphs 37-39)	The policyholder will receive a substantial share of the total return on underlying items (paragraphs 44-45)	Policyholders receives the returns from the underlying items that the entity holds (paragraph 67(a))	The entity has no discretion over the returns to the policyholder (paragraph 67(b))	The policyholder receives a substantial share of the returns (paragraph 67(c))
Staff recommended criterion	Recommended	Recommended	Not recommended	Recommended	Recommended	Not recommended	Recommended
90%. The actual amount to be paid is unknown until declared each year by the insurer.		more than a determined percentage (eg 95%).					
Fixed 90/10 The entity is only entitled to receive 10% of earnings on the business. All other earnings must be paid to policyholders. However, dividends are not necessarily paid in the year earned.	Yes	Yes	No. The insurer shares in the returns.	Yes	Yes	Discretion in timing.	Yes
With profits The returns on the underlying items are typically volatile; consequently, a large proportion of the returns are distributed at the end. The annual bonus (ie regular or reversionary bonus) is often small, reflecting the uncertainty in the sustainability of current returns. Bonuses are declared when deemed supportable/certain. The insurer may choose not to declare annual bonuses if returns are	Yes	Depends on whether there is a determinable amount that will be returned to the insurer that is not subject to discretion.	No. The insurer shares in the returns.	Yes	Yes	Depends. At least, discretion in timing.	Yes

Description of some types of participating contracts	When there is an implicit fee?				When it is appropriate to use book yield?		
	Underlying items held determine the returns to be passed to the policyholder (paragraphs 30-33)	Minimum amount that the entity must retain (paragraphs 34-36)	Entity receives a fixed amount or a percentage of both the underlying items and the returns ⁵ (paragraphs 37-39)	The policyholder will receive a substantial share of the total return on underlying items (paragraphs 44-45)	Policyholders receives the returns from the underlying items that the entity holds (paragraph 67(a))	The entity has no discretion over the returns to the policyholder (paragraph 67(b))	The policyholder receives a substantial share of the returns (paragraph 67(c))
Staff recommended criterion	Recommended	Recommended	Not recommended	Recommended	Recommended	Not recommended	Recommended
unsustainable. The final bonus (ie terminal bonus) is calculated when the policy matures, or is surrendered close to maturity, and is determined so that the policyholders get their fair share of the returns. The insurer’s share in the distribution of surpluses is in direct proportion to the provision of the guaranteed bonuses over the duration of the contract.							
No guaranteed participation rate Participation is not typically guaranteed. Dividends are determined annually by the board of directors. There may not be a fixed spread or other element that determines the amount paid. Terminal bonuses are often paid but are not generally important.	Yes	No	Depends.	Depends. If the underlying items are from the general fund, typically these may not be substantial.	Yes	Discretion in amount.	Depends. If the underlying items are from the general fund, typically these may not be substantial.
Variable/Unit-linked 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	Yes	Yes	Yes	Yes	Yes	Yes.	Yes

Description of some types of participating contracts	When there is an implicit fee?				When it is appropriate to use book yield?		
	Underlying items held determine the returns to be passed to the policyholder (paragraphs 30-33)	Minimum amount that the entity must retain (paragraphs 34-36)	Entity receives a fixed amount or a percentage of both the underlying items and the returns ⁵ (paragraphs 37-39)	The policyholder will receive a substantial share of the total return on underlying items (paragraphs 44-45)	Policyholders receives the returns from the underlying items that the entity holds (paragraph 67(a))	The entity has no discretion over the returns to the policyholder (paragraph 67(b))	The policyholder receives a substantial share of the returns (paragraph 67(c))
Staff recommended criterion	Recommended	Recommended	Not recommended	Recommended	Recommended	Not recommended	Recommended
specified pool of assets held by the insurer or by a third party and operated in a manner similar to a mutual fund). An entity may hold some of the units in the fund. ⁶							
Universal life Amounts credited are discretionary. Often based on a fixed spread over the yields of underlying items and subject to a minimum return	Yes	No	No	Depends	Yes	Discretion in amount and timing.	Depends

⁶ As discussed in paragraph 48, the suggested criteria would mean that there is an implicit asset management fee that exists beyond the explicit fees. Many do think that the insurer’s share of the fund qualifies as an implicit management fee. To address this, there would be the need to explicitly state that these insurer’s shares do not represent an implicit management fee.