

World Standard-setters Meeting

Smaller group sessions:
Insurance contracts



World Standard-setters Meeting

Tuesday 30 September 2014
The Grange City Hotel (London)

Smaller group sessions
Insurance contracts

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Insurance Contracts Project Update

World Standard Setters, September 2014

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.


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Today's topics 2

- Need to improve existing accounting for insurance contracts
- The IASB's project on insurance contracts
- Key proposals
- Comprehensive due process
 - 2013 Exposure Draft *Insurance Contracts*
 - Summary of feedback
- Key remaining issues
- Next steps


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Need to improve existing accounting for insurance contracts 3

| Existing issues | How our proposals improve accounting |
|--|---|
| Variety of accounting treatments depending on type of contract and type of company that issues the contracts | Consistent accounting for all insurance contracts by all companies (not just insurance companies) |
| Estimates for long duration contracts not updated | Estimates updated to reflect current market-based information |
| Discount rate based on estimates of investment returns does not reflect economic risks of insurance contract | Discount rate reflects characteristics of the cash flows of the contract |
| Lack of discounting for measurement of some contracts | Measurement of insurance contract reflects discounting where significant |
| Little information about economic value of embedded options and guarantees | Measurement reflects information about full range of possible outcomes |


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The IASB is developing an IFRS that would be applied by all entities that issue insurance contracts 4

- The new IFRS would:
 - replace IFRS 4 *Insurance Contracts*, which grandfathers existing diverse practices.
 - bring consistency to the measurement and presentation of insurance contracts, allowing comparisons across entities, jurisdictions and industries.
 - require an entity to apply relevant and reliable accounting policies to insurance contracts that reflects the full range of possible outcomes
 - provide transparent information about:
 - the way an entity makes profits or losses through underwriting activity and investing premiums from customers.
 - the nature and extent of risks from insurance contracts.

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Key proposals 5

Current, market-consistent measurement

Contractual service margin
(Contract profit)

"Fulfilment cash flows"

Future cash flows: expected cash flows from premiums and claims and benefits


Risk adjustment: an assessment of the uncertainty about the amount of future cash flows

Discounting: an adjustment that converts future cash flows into current amounts

Contractual service margin (CSM)
A component of the measurement of the insurance contract representing the risk-adjusted expected profit from the contract.

Fulfilment cash flows
A current, updated estimate of the amounts the entity expects to collect from premiums and pay out for claims, benefits and expenses, adjusted for risk and the time value of money.

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Key proposals 6

Up-to-date information about performance

Contractual service margin
(Expected contract profit)

"Fulfilment cash flows"

Future cash flows: expected cash flows from premiums and claims and benefits


Risk adjustment: an assessment of the uncertainty about the amount of future cash flows

Discounting: an adjustment that converts future cash flows into current amounts

| Statement of Comprehensive Income | | 20XX |
|---|-----------|------|
| Insurance contracts revenue | X | |
| Incurred claims and expenses | (X) | |
| Operating result | X | |
| Investment income | X | |
| Interest on insurance liability | (X) | |
| Investment result | X | |
| Profit or loss | X | |
| Effect of discount rate changes on insurance liability (optional) | (X) | |
| Total comprehensive income | XX | |

1. Changes in estimates relating to future services
2. All other expected changes in estimates
3. Based on a cost view
4. Based on a current view

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Key proposals Disclosures

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Amounts

- Expected present value of future payments & receipts
- Changes in risk during the period
- Changes in unearned profit during the period
- Effects of new contracts written in the period

Judgements

- Processes for estimating inputs and methods used
- Effect of changes on methods and inputs used
- Explanation of reason for change, identifying type of contracts affected

Risks

- Nature and extent of risks arising from insurance contracts
- Extent of mitigation of risks arising from reinsurance and participation features
- Quantitative information about exposure to credit, market and liquidity risk

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Extensive consultation

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Consultation documents issued

- 2007 Discussion Paper *Preliminary Views on Insurance Contracts*
- 2010 Exposure Draft *Insurance Contracts*
- 2013 Exposure Draft *Insurance Contracts*

The 2013 Exposure Draft:

- builds on previous consultations
- seeks feedback on changes to 2010 Exposure Draft
- focuses on operational and reporting complexity of revised proposals

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Five targeted areas

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Measurement proposals

- 1. Unlocking**
Changes in estimates relating to expected contract profit for providing coverage recognised over remaining period
- 2. Mirroring**
Measurement and presentation exception when no economic mismatch is possible

Presentation proposals

- 3. Revenue**
Align to presentation of revenue required for other types of contracts with customers
- 4. OCI proposals**
Interest expense is amortised cost-based in profit or loss, current value-on the balance sheet

Approach to transition

- 5. Transition**
Apply Standard retrospectively if practicable, or with specified simplifications if not practicable

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Who we heard from

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- 194 comment letters
- 187 outreach meetings, including discussion forums in 18 countries
- Third round of field work
 - 17 entities outside European Union directly
 - 13 entities within European Union, co-ordinated with EFRAG and European standard-setters
- Comment letter summaries discussed in January 2014 and redeliberations began in March 2014

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What we heard

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- Welcome progress made since 2010 exposure draft
- Acknowledgement that IASB has responded to concerns raised on the 2010 exposure draft
- Widespread agreement with direction of proposals relating to:
 - unlocking of contractual service margin
 - transition
- Support at a conceptual level for insurance contract revenue



- Overarching concern about extent of accounting mismatches. As a result:
 - Concern about scope of mirroring exception
 - Concern about mandatory OCI
- Significant concerns that mirroring:
 - Cannot be made operational
 - Does not sufficiently address accounting mismatches overall to justify the complexity
 - Would require options and guarantees to be reported in P&L

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IASB has substantially completed redeliberations for contracts with no participating features

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| | |
|---------------|---|
| Revenue | <ul style="list-style-type: none"> • An entity should present revenue as earned and expenses as incurred in the statement of comprehensive income. Revenue excludes investment components. • Presentation of premium information in the statement of comprehensive income prohibited if that information is not consistent with commonly understood notions of revenue. |
| Unlocking CSM | <ul style="list-style-type: none"> • CSM adjusted for changes between current and previous estimates of the risk adjustment and the present value of future cash flows • Recognise favourable changes in estimates in profit or loss to the extent that they reverse losses that relate to future services |
| OCI | <ul style="list-style-type: none"> • Effect of changes in discount rates presented in either profit and loss or in OCI as accounting policy choice |

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IASB has addressed some issues raised that were not targeted for input in the 2013 ED

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| | |
|---|--|
| 1 | Option to include fixed fee service contracts within scope of insurance contracts standard. |
| 2 | Additional guidance on use of judgement in making any necessary adjustments to observable inputs to determine the discount rate. |
| 3 | Recognise contractual service margin in profit or loss in a way that reflects the passage of time and the expected number of contracts in force |
| 4 | Symmetrical treatment for changes in estimates of fulfilment cash flows for a reinsurance contract and the underlying direct insurance contract |
| 5 | Contracts acquired in settlement period should be accounted for as if issued by entity at the date of portfolio transfer or business combination |
| 6 | Clarified objectives relating to level of aggregation |
| 7 | Clarify that significant insurance risk only occurs when there is a possibility that an issuer will incur a loss on a present value basis |
| 8 | Confirm use of locked-in rate for accruing interest and for determining the amount that unlocks the contractual service margin. |

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Difficult issues relating to participating contracts yet to be addressed

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The IASB plans to consider transition in the light of a near-final model

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- General support for principle of retrospective application
- But:
 - Concerns about availability of cash flow data even for proposed simplifications
 - Requests for further simplification, eg determining portfolios at date of transition, opening OCI balance
 - Concerns about depiction of contracts that are profitable overall, despite adverse investment experience

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For more information...

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Ask questions or share your views

- Email us: insurancecontracts@ifrs.org

Resources on IASB website

- IASB Update
- Project podcasts and webcasts
- Snapshot
- Feedback statement
- Investor resources
- High level summary of project

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NOTES

STAFF PAPER

May 2014

REG IASB Meeting

| | | | |
|--------------------|---|---------------------|--|
| Project | Insurance contracts | | |
| Paper topic | Contracts with participating features: Background | | |
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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*.

Purpose of the paper

1. This paper has been provided as background for Agenda Paper 2B and should be read in conjunction with that paper. It describes:
 - (a) The participating features that can be included in insurance contracts;
 - (b) The proposals in the 2013 Exposure Draft *Insurance Contracts* for contracts with participating features; and
 - (c) The response to the proposals in the comment letters.
2. Appendix A describes some characteristics of contracts with participating features, and Appendix B sets out the relevant references to the 2013 ED.
3. This paper does not ask any questions.

Participating features in insurance contracts***What are participating features?***

4. Insurance contracts always provide payments to policyholders that depend on the occurrence of an insured event, and these payments do not vary with the return on underlying items. However, many insurance contracts also provide payments to

policyholders that vary with the returns on underlying items. We describe the feature in contracts that result in such payments as a participating feature.

5. Insurance contracts that contain participating features vary both within jurisdictions and between jurisdictions. Appendix A describes some characteristics of contracts with participating features and Appendix B describes some of the variations. However, all contracts considered in this paper include the following features:
 - (a) The (individual) policyholder transfers insurance risk to the insurer in exchange for a premium, and thus receives insurance protection.¹
 - (b) The entity invests the premium in underlying items, and includes the underlying items in its financial statements (ie the underlying items are treated as assets and liabilities of the entity).
 - (c) The overall performance of the underlying items is shared between the entity and the community of policyholders as a whole (the participating feature).
6. This section considers the following characteristics of contracts with participating features:
 - (a) Payments to policyholders (paragraphs 7-8);
 - (b) Options and guarantees embedded in contracts with insurance contracts (paragraphs 9-11); and
 - (c) Sources of profit to the entity (paragraph 12).

Payments to policyholders

7. There is a wide variety in the payments that arise from participating features:
 - (a) The payments can be specified in different ways, eg as a share of the returns from underlying items, as an amount credited to the policyholder which is set depending on the performance of underlying items, and the explicit or implicit deduction of fees.

¹ Much of this paper would also apply to investment contracts with discretionary participation features, which are within the scope of the proposed Standard. However, those contracts would not transfer any insurance risk.

- (b) There may be restrictions on when the policyholder can receive payments, for example on the earlier of an insured event or a specified maturity date, and at specified withdrawal dates. Alternatively, the policyholder's could have unrestricted access but may be subject to surrender penalties.
 - (c) The underlying items may include specified assets or investments, groups of assets or liabilities or the profits of an entity. In more complex situations, the underlying items may be specified in terms of a combination of mortality experience, expenses and investment returns.
 - (d) The underlying items can either be held directly by the entity, or be used as a reference point to determine the cash flows that will be paid to policyholders (eg in index-linked contracts or contracts that return the performance of all assets held by the insurer, including those that are not segregated, such as general account assets).
8. The defining characteristic of contracts with participating features is that the entity shares some of the investment risks with the policyholder. However, the contractual terms of the contract may permit an element of management discretion over the extent to which the payments to policyholder follow the returns on the underlying items. For example:
- (a) In some cases, the contract may be prescriptive about the amounts that are paid to the policyholder in different circumstances, for example because of options or guarantees embedded in insurance contracts (see paragraphs 9-11).
 - (b) In other cases, the contract may allow the entity to exercise discretion, for example:
 - (i) about the amount of the payments to policyholders. The entity may have the discretion to limit the returns on policyholders through an explicit or implicit cap on payments.
 - (ii) about the timing of the payments to policyholders. A common feature of such contracts is that some payments to policyholders may be specified for the pool of policyholders as a whole, rather than to individual policyholders. This means that the payments owed to a policyholder leaving a

pool may be paid to a new policyholder joining the pool instead.

- (iii) about the amount of the fees or charges. Some contracts permit the insurer to determine the fees or charges within a predefined range. In effect, fees or charges reduce or increase the cash outflows to the policyholders.

Options and guarantees embedded in contracts with participating features

9. A common feature of contracts with participating features is that the entity is restricted by the presence of options or guarantees embedded in insurance contracts. Such options and guarantees specify the payments that the entity will not be able to avoid making to policyholders in particular circumstances. The following table contains typical options and guarantees embedded in these contracts.

| Examples of options and guarantees |
|--|
| <p><i>Guaranteed death benefit</i></p> <p>The entity makes a payment on the death of the policyholder. The death benefit does not depend on the amount the policyholder has invested.</p> |
| <p><i>Guaranteed minimum death benefit (GMDB)</i></p> <p>The policyholder invests premiums which accumulate over time. The entity guarantees that there is a minimum amount that the policyholder will receive in event of death. That minimum amount may be based on the amount of premiums invested.</p> |
| <p><i>Guaranteed minimum accumulation benefit (GMAB)</i></p> <p>The entity makes a payment on surrender or maturity. The entity guarantees that pay outs will be a minimum amount at a point in time.</p> |
| <p><i>Guaranteed Annuity Option (GAO)</i></p> <p>The policyholder invests premiums which accumulate over time. At a point in the future the accumulated funds are converted to an annuity at a rate at least as favorable as a rate agreed at inception. The entity then makes annuity payments until the policyholder dies.</p> |

10. The staff have used the term ‘guarantees’ to describe payments that the entity has no discretion to avoid. Such guarantees include:

- (a) insurance guarantees, in which the entity has no discretion to avoid payments to policyholders that occur when an insured event occurs.
- (b) financial guarantees to the policyholder about the return on the invested premium that is attributed to the policyholder. Depending on the terms of the contract, the payments to the policyholder could be made on maturity or withdrawal. Financial guarantees provide payments to policyholders that do not vary directly on the returns on the assets that the entity acquired using the premiums paid in by the policyholder. In effect, financial guarantees provide the policyholder with the option to receive the higher of a fixed amount and the returns on the investment.
- (c) a combination of an insurance and a financial guarantee, for example in the case of a financial guarantee that is paid only on the occurrence of an insured event.

11. Financial guarantees embedded in an insurance contract result in cash flows that are similar to the cash flows in financial instruments that are within the scope of IFRS 9 *Financial Instruments*. Accordingly, the proposals in the ED would have required the entity to unbundle and apply IFRS 9 to financial guarantees that meet the definition of distinct investment components or embedded derivatives. Distinct investment components or embedded derivatives would occur if the terms of the contract clearly specified the payments from the participating feature in all circumstances, and include specified equity-index, commodity index, foreign currency derivatives, and specified minimum interest guarantees with dissimilar risks from the host insurance contract. However, the difficulty arises when the investment component is **not** distinct, because the investment component and the insurance component are highly interrelated as described in paragraph B32 of the ED. Such components are not unbundled, but accounted for together with the rest of the insurance contract as a whole.

Sources of profit for the entity in contracts with participating features

12. An entity may use a combination of fees/charges and expected returns as sources of profits from contracts with participating features:
- (a) In some cases, a contract with a participating feature may pass all of the investment returns on underlying items to the policyholder, subject to

explicit fees, as in the case of some unit-linked contracts. However in most cases, the entity expects to make profits by retaining some of the investment returns from underlying items that were purchased using the premium paid by the policyholder.

- (b) An entity may apply a fee or charge, for example cost of insurance charges, mortality charges or asset management charges. Such fees and charges may be flat rate, based on a nominal account balance (ie a fund value) or based on the returns achieved. The fees or charges may be applied when premiums are paid, throughout the contract term, on exit, or any combination of these. Paragraph 10(c) of the 2013 ED propose that an entity should unbundle and apply other applicable standards to a distinct performance obligation to provide services, including asset management services. However, asset management services are sometimes not a distinct performance obligation, for example if the cash flows and risks associated with the service are highly interrelated with the cash flows and risks associated with the insurance components in the contract, and the entity provides a significant service of integrating the good or service with the insurance components. Such asset management fees are not unbundled, but accounted for together with the rest of the insurance contract as a whole

The proposals in the 2013 ED

13. According to the proposals in the 2013 ED, an entity measures an insurance contract at initial recognition at the sum of:
- (a) the amount of the fulfilment cash flows²; and
 - (b) a contractual service margin, which calibrates the measurement of the insurance contract at initial recognition to the expected premiums.
14. After initial recognition, the insurance contract is measured at the sum of:
- (a) the fulfilment cash flows at that date; and

² Fulfilment cash flows are the explicit, unbiased and probability-weighted estimate (ie expected value) of the present value of the future cash outflows less the present value of the future cash inflows that will arise as the entity fulfils the insurance contract, including a risk adjustment.

- (b) the remaining amount of the contractual service margin, which is determined as the carrying amount of the contractual service margin at the start of the period, adjusted to reflect:
 - (i) the accretion of interest on the contractual service margin
 - (ii) the amount of the contractual service margin recognised in profit or loss in the period. Agenda paper 2C discusses the recognition pattern of the margin for non-participating contracts.
 - (iii) differences between the current and previous estimates of the present value of cash flows related to future coverage and other future services, subject to the condition that the contractual service margin should not be negative.

- 15. At its March 2014 meeting, the IASB tentatively decided to adjust the margin after inception to reflect differences between the current and previous estimates of the present value of cash flows and the risk adjustment related to future coverage and other future services. Those differences should be added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative.

- 16. Thus, the proposals in the ED represent an insurance contract as comprising both:
 - (a) An obligation to pay net future cash outflows, represented by the fulfilment cash flows; and
 - (b) An obligation to provide insurance coverage over the coverage period (ie a performance obligation), represented by the contractual service margin.

Together, the fulfilment cash flows and the contractual service margin provide an updated representation of the entity's obligations in the insurance contract.

Applying the general proposals in the ED to contracts with participating features

- 17. The general proposals in the ED would apply to contracts with participating features as follows:

- (a) The entity would measure the insurance contract on the basis of the risk-adjusted expected present value of cash flows (ie the fulfillment cash flows). In determining the fulfillment cash flows:
 - (i) The entity includes all the cash flows that arise from the rights to share in the returns on underlying items . Such cash flows include contractual and discretionary cash flows, and cash flows arising from existing contracts regardless of whether paid to current or future policyholders.
 - (ii) The entity discounts the expected cash flows using discount rates that reflect the characteristics of the cash flows of the liability. When the amount, timing of uncertainty of cash flows arising from an insurance contract depends wholly or partly on the returns on underlying items, the characteristics of the cash flows of the liability include that dependence and the discount rate used to measure the insurance contract should also reflect that dependence.

 - (b) The entity would present in profit and loss the interest expense determined at the date when the contract was initially recognized. For cash flows that vary directly with returns on underlying items, the entity would update those discount rates when it expects changes in those returns to affect the amount of those cash flows. Thus, the interest expense recognised in profit and loss relating to cash flows that vary with the returns on underlying items would be akin to the interest from a variable rate financial instrument measured at amortised cost or fair value through other comprehensive income.

 - (c) The entity would present in other comprehensive income the difference between:
 - (i) interest expense determined using the discount rate at reporting date (ie the current discount rate); and
 - (ii) interest expense recognized in profit or loss.
18. Applying these general proposals in the 2013 ED, the measurement of the insurance contract would reflect current expectations about all the future cash flows paid as a result of investment returns on underlying items, in the same way that the fair value of

the underlying items would reflect current expectations of all the future cash flows from investment returns on underlying items. Accordingly, when the underlying items are measured at fair value through profit or loss, there would be substantially no mismatches between the cash flows from the contract and the underlying items.

19. However, accounting mismatches could still arise when the underlying items are not measured at fair value through profit or loss. Therefore, the 2013 ED proposed that there should be a measurement and presentation exception for some types of contracts with participating features. This exception is commonly referred to as the “mirroring exception”. The mirroring exception was intended to eliminate all accounting mismatches between the cash flows of the contract and the cash flows of the underlying items and would apply only to contracts for which there could be no possibility of an economic mismatch. The ED specified that this would be the case for contracts for which the entity is required to pass on returns from underlying items to the policyholder and for which the entity is required to hold those underlying items.

Applying the mirroring exception

20. To apply the mirroring exception, an entity would identify, and apply different measurement bases to:
- (a) cash flows that varied directly with underlying items, which would be measured on the same basis as the underlying items; as distinct from
 - (b) all other cash flows, which would be measured using the general approach in the ED.

Some refer to the separation of cash flows in this way as bifurcating, or decomposing, the cash flows.

21. An entity would present changes in the cash flows that varied directly with underlying items on the same bases as the presentation of the underlying items. However, there are differences in the presentation of changes in the other cash flows, as follows:
- (a) changes in cash flows that vary indirectly with underlying items would be presented in profit or loss; and

- (b) changes in cash flows that are fixed or that do not vary (directly or indirectly) with underlying items are presented in accordance with the general requirements of the ED, ie:
 - (i) as an offset to the contractual service margin, for changes in estimates of cash flows that relate to future service;
 - (ii) in profit and loss, for changes in estimates of cash flows that do not relate to future service, and for the risk adjustment; and
 - (iii) in OCI for the effect of changes in the discount rate.

22. Thus, the Exposure Draft proposed different presentation requirements for changes in the fulfilment cash flows that vary indirectly with underlying items (which are intended to include embedded options and guarantees), depending on whether the contract met the criteria for mirroring, as follows:

- (a) When mirroring applies, the changes in the fulfilment cash flows that vary indirectly with underlying items would be presented in profit or loss.
- (b) When mirroring does not apply, the changes in the fulfilment cash flows that vary indirectly with underlying items are recognised as described in paragraph 21(b).

The response to the proposals in the comment letters

23. Many constituents disagree that some types of participating insurance contract should be measured and presented on a different basis from other insurance contracts. Those with this view were concerned that this would result in reduced comparability, for example:

- (a) between the measurement of contracts to which mirroring applies, and those to which it does not;
- (b) between the presentation of the options and guarantees embedded in insurance contracts to which mirroring is applied, and those to which it is not (and to options and guarantees embedded in contracts that are not insurance contracts); and

- (c) within the mirroring approach, between an insurance contract for which the entity accounts for the assets backing the contract at amortised cost, and an otherwise identical contract for which the entity accounts for the assets backing the contract at fair value.
24. Some believe that the marked difference in accounting does not reflect the more subtle differences in contract characteristics, and believe the proposals to portray a misleading difference.
 25. Question 2 of the ED asked for respondents' views on contracts that would be eligible for the mirroring exception. However, although the ED did not ask an explicit question about the proposals for contracts in which there is dependence on underlying items when the mirroring exception would not apply, some constituents also raised their concerns.
 26. Some requested further clarification on most of the aspects of the proposals. It appears that there was widespread confusion on scope of the proposals and how the mirroring exception would be applied to the many variations of contracts with participating features.
 27. This section describes a high level summary respondents' views on:
 - (a) The accounting for contracts with participating features that are not eligible for the mirroring exception (paragraphs 28-33);
 - (b) The scope of the mirroring exception (paragraphs 34-38);
 - (c) The accounting for contracts that are eligible for the mirroring exception (paragraphs 39-44); and
 - (d) Alternative proposals described in the comment letters for the accounting for contracts with participating features (see paragraphs 45-47).

Further details are provided in agenda paper 2B where relevant.

Contracts with participating features that are not eligible for the mirroring exception

28. Some respondents were concerned that the application of the general proposals in the ED would require entities to apply different discount rates to different types of cash

flows within a contract with a participating feature because of the following proposals:

- (a) The proposal that discount rates should reflect the extent to which the cash flows depend on asset returns.
 - (b) The proposal to determine interest expense in profit or loss on the basis of the locked-in discount rate, updated when the entity expects any changes in returns on underlying items to affect the amount of cash flows. Some interpreted this requirement as implying that an entity is required to apply separate discount rates to each set of cash flows.
29. Respondents with this concern believe that any requirement to apply different discount rates to different types of cash flows would result in excessive operational complexity. They recommend instead that a single discount rate should be applied to all cash flows that do not qualify for mirroring.
30. Some observe that in a contract with participating features, the investment returns that are not passed to the policyholder result in profit for the entity. Some believe that changes in estimates of such profits should adjust the contractual service margin, because such amounts would affect the amount of profit the entity is expected to earn from the combined effect of the insurance contracts and the assets held to provide the returns promised in the contract.
31. These suggested adaptations to the general model are discussed further in Agenda paper 2B.
32. Some noted a lack of clarity over the requirements for determining interest expense, as follows:
- (a) It was unclear when the entity should update the discount rate to reflect changes in returns on underlying items that affect the cash flows. For example, within a universal life contract, there could be different interpretations about whether a fixed death benefit varies or does not vary directly with returns on underlying items:
 - (i) If the fixed death benefit is regarded as fixed, the entity would apply a discount rate locked-in at inception.

- (ii) However, universal life contracts often lapse if the account balance goes to zero, in which case the death benefit will not be paid. Because the account balance is directly dependent on the level of credited rates, which are directly dependent on returns on the underlying items, some consider these death benefit cash flows as varying directly with returns on underlying items. Accordingly they would discount these cash flows using a rate that is updated when there the entity expects any changes in returns from underlying items to affect the amount of cash flows.
 - (b) Some seek clarification on whether the discount rate should be updated to the current, market-consistent liability rate. Some suggest instead that interest expense presented in profit or loss should be determined as the book yield on the backing assets, ie an amount based on the return on the assets backing insurance contracts that is recognised in profit or loss in the period or an amount calculated using an effective rate/level yield method.
33. Some suggest the use of OCI for presenting specified changes in insurance contract liabilities should be optional. In March 2014, the IASB decided that, for non-participating contracts, entities should choose to present the effect of changes in discount rates in profit and loss or in other comprehensive income as its accounting policy and should apply that accounting policy to all contracts within a portfolio, subject to further guidance that would be developed. We will consider as part of the deliberations on contracts with participating features, whether the IASB should extend that decision to contracts with participating features.

Scope of the mirroring exception

34. The ED proposed that an entity would apply the mirroring exception only if the contract:
- (a) Requires the entity to hold the underlying items; and
 - (b) Specifies a link between the payments to the policyholder and the returns on those underlying items.

35. Many constituents found these requirements unclear. As a result, there was diversity in the interpretation of the scope, and some participants were uncertain whether mirroring would apply to particular contracts. Particular issues identified were:
- (a) In some cases, the requirement to hold assets is specified by a regulator, rather than by the contract. It appears that some had interpreted such contracts as being outside the scope of mirroring.
 - (b) In some cases, the payments to policyholders reflect a large number of factors, including management discretion. Some interpreted the proposals as requiring the entity to identify any traceable link to underlying assets, and to apply mirroring to those cash flows.
 - (c) Some ask whether the mirroring approach would be applied in cases in which there is discretion over the timing of the distribution or allocation of profits on participating contracts to policyholders.
 - (d) Some ask how the mirroring approach would be applied to charges that are based on the amounts attributable to the policyholder.
36. Some think that the proposals would be workable only for the simplest participating contracts, such as those in segregated fund arrangements. For such contracts, almost all the cash flows from the contract would vary directly with the underlying items, and the decomposition of cash flows would not be arbitrary.
37. Some mutual entities questioned the complexity of applying the proposals to participating contracts when the ultimate surplus will ultimately be distributed to policyholders in their capacity as owners. However, some note that the ultimate outcome for a mutual is that the entire surplus must be shared between policyholders and thus think that mirroring would be necessary to avoid accounting mismatches.
38. Some respondents observed that the criteria for the mirroring exception would mean that there would be a relatively narrow number of contracts to which the mirroring exception could apply. Some believe that the complexity that would be introduced by having different accounting approaches for different types of contracts would not be justified because of this narrow scope would mean that only some and not all accounting mismatches would be avoided. In contrast, some suggest retaining the mirroring proposals, but restricting the scope to mutual and unit-linked/segregated

fund contracts, possibly on an optional basis (see paragraphs 36 and 37). The staff plans to consider if a mirroring approach is needed after considering what adaptations are needed to the general model to account for contracts with participating features.

Contracts that are eligible for the mirroring exception

39. Some respondents, for example in Canada and Asia, supported the mirroring exception because it would eliminate accounting mismatches when the terms of the contract mean the entity will not suffer any economic mismatches. They agreed that the mirroring exception would result in a faithful representation of the fact that the amount the entity is obligated to pay is equivalent to the value of the underlying items.
40. However, many constituents had significant concerns about the mirroring proposals in paragraphs 33 and 34 of the ED. While most were sympathetic to the IASB's intention of eliminating accounting mismatches using a mirroring approach, most objected to the specific proposals in the ED for doing so.
41. Some are concerned about the depiction of an insurance contract that is measured using the mirroring exception. In particular, some preparers and regulators are concerned that when the underlying items are measured at cost, the carrying value of the insurance contract would not be a current value. As a result, it would widen the difference between the liability measured for financial reporting purposes, and the liability recognised for regulatory purposes in some jurisdictions.
42. However the main concern about the mirroring exception related to the perceived complexity of applying the approach.
43. Many constituents believe that it would be difficult for entities to identify the component of the insurance contract that would be measured on the basis of the underlying items (especially if the underlying items were measured using different accounting bases), and the component of the insurance contract that would be measured according to the general proposals in the ED. They observe that the IASB's model was designed to treat an insurance contract as a bundle of rights and obligations, and that the IASB had previously decided that there should be limited unbundling of those rights and obligations, on the basis that it would be arbitrary and complex to do so. Accordingly, they believe that it would be difficult to separate and

separately measure part of the probability-weighted estimate of cash flows, particularly if the ED were to require a separation that does not align with the way that many insurers view their products. Their objections are:

- (a) Any decomposition of cash flows is arbitrary, yet different methods of decomposition would lead to different valuations of the insurance contract, and arbitrary measurement in the balance sheet or in the profit reported in the statement of comprehensive income.
- (b) When the guarantees embedded in the insurance contract vary from year to year, the entity would need to decompose and mirror a different proportion of the liability each year. Some constituents note that this would increase the operational difficulties of applying the mirroring proposals.
- (c) Some comment that they can separately measure the time value of options and guarantees under their existing practices. However, they would not be able to divide them into a component to be recognised in P&L and a component to be recognised in OCI.

These concerns are similar to those described in 28 and 29 about applying different discount rates to different sets of cash flows.

44. Finally, some preparers are concerned that if an entity applies the mirroring approach at initial recognition, the contractual service margin could be mis-stated if the underlying items are not measured at fair value. Some note that the IASB would need to clarify that the contractual service margin should be determined on the basis of non-mirrored cash flows.

Alternative proposals for the accounting for contracts with participating features

45. Some doubt that the IASB would be able to resolve the practical difficulties with applying the mirroring proposals. In addition, some observe that, as a principle, accounting mismatches are best dealt with by consistency of measurement approaches rather than by exceptions. Accordingly, some suggest that there should be no measurement and presentation exception for participating contracts, but that the

general approach should instead be used to measure all insurance contracts at a current value.

46. However, views on how to address accounting mismatches between the cash flows of the insurance contract and the cash flows of the underlying items differ:
- (a) some propose that all insurance contract liabilities should be measured using the general proposals of the ED, and that any accounting mismatch should be dealt with by modifying the accounting for the underlying items instead.
 - (b) some observe that the main problem that the mirroring exception aims to solve could be dealt with much more simply, by allowing use of other comprehensive income to be optional rather than mandatory, as described in paragraph 33.
47. Some think that the general model proposed in the ED could be adapted for contracts with participating features, to address the concerns described in paragraphs 28-33. However, others propose alternative models for contracts with participating features. These alternative models are discussed in agenda paper 2B, which considers the possible adaptations to the general model proposed in the ED to reflect contracts with participating features.

Appendix A: Examples of participating contracts

This appendix sets out an extract from Appendix B of agenda paper 3F of the March 2011 Joint Board meeting.

- A1. The following information on country-specific types of participating contracts is based on an (internal) survey by members of the Insurance Accounting Committee of the International Actuarial Association (IAA). We thank them for providing the information. They are not responsible for how the staff have summarised the information.
- A2. Belgian participating contracts provide a contractual right to share in surplus, but usually do not give specific guidance on how the policyholder participates in the surplus or which share belongs to the policyholder. The insurer determines annually the policyholders' share of surplus, which is solely based on the insurer's discretion (the insurer is entirely free to pay the policyholder any amount between 0 to 100% of the surplus). After determining the policyholders' share in surplus for the current year, the Belgian regulators require the insurer to pay out 80% of the amounts set aside for allocation to policyholders in the following year. The remaining 20% are to be payable to policyholders in later periods.
- A3. Finnish participating contracts determine the policyholders' share entirely based on the insurer's discretion. Actual payments are only driven by competitive market pressure. The insurer decides when to realise surpluses, the individual policyholder's share in that surplus and the timing of the actual allocation. The regulator ensures that the insurer does not allocate surpluses if doing so potentially endangers the insurer's financial stability.
- A4. South African life insurers have discretion on the policyholders' share in surplus, as well as on the amount and timing of its allocation or distribution to the individual policyholder. The amounts set aside for policyholders can be negative if they are expected to be recovered during the following three years.
- A5. In Australia the policyholders' share in surplus is set aside and allocated to the individual policyholder according to a formula. Legally, the insurer is obliged to set aside 80% of the surplus for policyholders. Some contracts grant an even higher percentage. The amount set aside may become negative and carried forward. If the insurer voluntarily pays more than 80% (or whatever contractually is required), that can be carried forward, thus reducing future amounts to be set aside to pay dividends to future policyholders.
- A6. Canadian participating contracts require an annual allocation of amounts to individual policyholders, payable immediately in the following year. Law requires that the directors must adopt a formal dividend policy and adopt methods for allocation, which an appointed actuary must approve. In Canada there is little discretion in determining the amount or timing of the surplus once allocated. The contribution principle is followed, with the Appointed Actuary recommending dividends to the entity's Board.

- A7. Most Japanese participating contracts force the insurer to immediately set aside policyholders' contractually specified share in the realised surplus. These amounts are not immediately payable to the individual policyholder, but rather are aggregated over time. The timing of the irrevocable allocation is at the discretion of the insurer, even though the surplus is already realised. The amounts set aside are revocable and loss absorbing, including those referring to future periods of the individual contract.
- A8. In the US, the types of contracts are diverse, partly due to significantly different state regulations. Some states allow insurers to apply significant discretion in declaring dividend scales; however, overall they are subject to regulatory control. Regulators are expected to intervene in case of inadequate dividend scales, but that remains untested since in the past all insurers acted in accordance with regulatory rules. If stock insurers issue participating contracts, the amounts distributable to stockholders may be limited by some state laws.
- A9. In the UK participating features are contractually and legally established. The sources to determine the surplus need to be specified and may include sources from non-participating contracts. Policyholders' individual share is typically required to be at least nine times of any allocation to shareholders from aggregated unallocated surplus, to be allocated immediately to policyholders when amounts are allocated to shareholders.
- A10. In the Czech Republic and Slovakia participating contracts determine the policyholder's share as a fixed percentage of the realised surplus. The insurer's only discretion is when to realise the surplus, as there is no discretion on timing of allocation or amount of payment to the individual policyholder.
- A11. Norwegian law prescribes that the policyholders' share in surpluses has to be two thirds of each annual surplus (partly including unrealised gains). When policies terminate, there is an obligatory payment of 75% of any surpluses (including unrealised gains) determined at that point in time. Insurers can decide when to realise gains (apart from terminating contracts), but there is no further discretion available.
- A12. In Italy the participation feature is guaranteed by law to be an entity-wide average of 85% of the realised surpluses (unrealised gains and losses excluded). The exact policyholder's share in the surplus is specified in the individual contract as a specific percentage of investment earnings. The individual policyholder receives its share every year according to the results of the previous year.
- A13. French life insurers issue participating investment contracts with a guaranteed minimum annual rate of return on premiums paid, a distinct share in investment returns on the entire surplus of the entity. Under French law the insurer can immediately forward shares in realised surplus to individual policyholders. The remaining amount of the overall required share for policyholders is set aside. However, the insurer has some discretion regarding the timing of the allocation to the individual policyholder. The allocation has to be done within 8 years. The amount set

aside can be used to cover subsequent losses to some extent and there might be as well a loss carry forward to be recovered by future surplus.

- A14. In some states in the US, e.g. New York, state law requires that the insurer sets a minimum percentage of surplus aside for ultimate distribution to policyholders each year. At the same time the law grants insurers some discretion regarding its ultimate allocation. The contribution principle is considered in this allocation.
- A15. In Germany, virtually all life insurance contracts are participating contracts. There are strict rules determining the share of recognised surplus that has to be set aside for participation of policyholders. Although the subsequent allocation of the amount set aside to individual policyholders is at the discretion of the insurer, the contribution principle is applied. Losses of a period are generally borne by the insurer. Unallocated amounts can be used to cover subsequent losses if otherwise the insurer would be in financial danger. If contracts terminate for any reason, the policyholder receives an appropriate share of unrealised gains allocable to its contract.

The following table provides a summary of the different mechanisms for allocating performance according to the types of participating contracts. It was adapted from HUB group discussion paper *Accounting for Insurance Contracts with Participating Features: Current-current through OCI with a Floating Residual Margin* dated 23 April 2012 , and is reproduced without change from agenda paper 2B for the IASB’s meeting in December 2012.

| Description of some types of participating contracts | Types of benefits | | | |
|--|--|--|--|--|
| | Guaranteed fixed by formula | Discretionary determined and paid at the discretion of the entity | Terminal determined and paid when the contract terminates | Unit-linked benefit linked to unit prices of an investment fund |
| 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 insurer usually decides to pay more than the 90%. The actual amount to be paid is unknown until declared each year by the insurer. | ✓ | ✓ | | |
| Fixed 90/10 The insurer 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. | ✓ | | | |
| 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 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. | | ✓ | | |
| 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 specified pool of assets held by the insurer or by a third party and operated in a manner similar to a mutual fund). | | | | ✓ |

Appendix B: ED proposals for contracts with participating features

From the standard

Relating to separating components from an insurance contract (paragraphs B31–B35)

- 9 An insurance contract may contain one or more components that would be within the scope of another Standard if they were separate contracts. For example, an insurance contract may include an investment component or a service component (or both). Such a contract may be partially within the scope of this [draft] Standard and partially within the scope of other Standards. An entity shall apply paragraphs 10–11 to identify and account for the components of the contract.
- 10 An entity shall:
- (a) separate an embedded derivative from the host contract and account for the embedded derivative in accordance with IFRS 9 if, and only if, it meets both of the following criteria:
 - (i) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see paragraphs B4.3.5 and B4.3.8 of IFRS 9); and
 - (ii) a separate financial instrument with the same terms as the embedded derivative would meet the definition of a derivative and would be within the scope of IFRS 9 (for example, the derivative itself is not an insurance contract).

The entity shall measure the embedded derivative as if it had issued it as a stand-alone financial instrument that is initially measured in accordance with IFRS 9 and attribute any remaining cash flows to the other components of the insurance contract.
 - (b) separate an investment component from the host insurance contract and account for it in accordance with IFRS 9 if that investment component is distinct (see paragraphs B31–B32). The entity shall measure a distinct investment component as if it had issued it as a stand-alone financial instrument that is initially measured in accordance with IFRS 9 and attribute any remaining cash flows to the other components of the insurance contract.
 - (c) separate from the host insurance contract a performance obligation (as defined in [draft] IFRS X Revenue from Contracts with Customers) to provide goods or services (see paragraphs B33–B35). The entity shall account for a distinct performance obligation to provide goods or services in accordance with paragraph 11 and other applicable Standards if that performance obligation to provide goods and services is distinct.
 - (d) apply this [draft] Standard to the remaining components of an insurance contract. Throughout this [draft] Standard, the components of an insurance contract that remain after separating the components within the scope of other Standards in accordance with (a)–(c) are deemed to be an insurance contract.
- 11 After applying paragraph 10 to separate any cash flows related to embedded derivatives and distinct investment components, an entity shall, on initial recognition:

- (a) attribute the remaining cash inflows between the insurance component and any distinct performance obligations to provide goods or services in accordance with [draft] IFRS X Revenue from Contracts with Customers; and
- (b) attribute the remaining cash outflows between the insurance component and any distinct performance obligations to provide goods or services in a way that attributes:
 - (i) cash outflows that relate directly to each component to that component; and
 - (ii) any remaining cash outflows on a rational and consistent basis, reflecting the costs that the entity would expect to incur if it had issued that component as a separate contract.

B31 Paragraph 10(b) requires an entity to separate a distinct investment component from the host insurance contract. Unless the investment component and insurance component are highly interrelated, an investment component is distinct if a contract with equivalent terms is sold, or could be sold, separately in the same market or same jurisdiction, either by entities that issue insurance contracts or by other parties. The entity shall take into account all information that is reasonably available in making this determination. The entity need not undertake an exhaustive search to identify whether an investment component is sold separately.

B32 An investment component and insurance component are highly interrelated if:

- (a) the entity is unable to measure the one without considering the other. Thus, if the value of one component varies according to the value of the other, an entity shall apply this [draft] Standard to account for the whole contract containing the investment component and the insurance component; or
- (b) the policyholder is unable to benefit from one component unless the other is also present. Thus, if the lapse or maturity of one component in a contract causes the lapse or maturity of the other, the entity shall apply this [draft] Standard to account for the whole contract containing the investment component and insurance component.

Relating to cash flows

B66 Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the portfolio of contracts and include:

...

- (k) payments arising from existing contracts that provide policyholders with a share in the returns on underlying items (see paragraph 33), regardless of whether those payments are made to current or future policyholders.

B67 The following cash flows shall not be considered when estimating the cash flow that will arise as the entity fulfils an existing insurance contract:

- (a) investment returns on underlying items. The investments are recognised, measured and presented separately. However, the measurement of an insurance contract may be affected by the cash flows, if any, that depend on the investment returns.
- (b)

B68 Paragraph 30 requires an adjustment to the remaining amount of the contractual service margin for a difference between the current and previous estimates of the cash flows that relate to future coverage and other future services. Accordingly:

...

- (d) the contractual service margin is not adjusted for changes in estimates of cash flows that depend on investment returns if those changes arise as a result of changes in the value of the underlying items. Such changes do not relate to services provided under the contract.
- (e) the contractual service margin is adjusted for changes in estimates of cash flows that are expected to vary directly with returns on underlying items only if those cash flows relate to future services under the insurance contract. For example, changes in cash flows relating to asset management services that are provided under a contract relate to future services under the insurance contract. Gains or losses on the underlying items do not relate to unearned profit from future services from the insurance contract and are recognised in accordance with the Standards relevant to the underlying items.

Relating to discount rates

26 Estimates of discount rates shall be consistent with other estimates used to measure the insurance contract to avoid double counting or omissions, for example:

- (a) to the extent that the amount, timing or uncertainty of the cash flows that arise from an insurance contract depends wholly or partly on the returns on underlying items, the characteristics of the liability reflect that dependence. The discount rate used to measure those cash flows shall therefore reflect the extent of that dependence.

...

B73 To the extent that the amount, timing or uncertainty of the cash flows that arise from an insurance contract depends on the returns on underlying items, paragraph 26(a) requires the characteristics of the liability to reflect that dependence. The discount rates used to measure those cash flows shall therefore reflect the extent of that dependence. This is the case regardless of whether that dependence arises as a result of contractual terms or through the entity exercising discretion, and regardless of whether the entity holds the underlying items.

B75 In some circumstances, the most appropriate way to reflect any dependence of the cash flows that arise from an insurance contract on specified assets might be to use a replicating portfolio technique (see paragraphs B46–B48). In other cases, an entity might use discount rates that are consistent with the measurement of those assets, and that have been adjusted for any asymmetry between the entity and the policyholders in the sharing of the risks arising from those assets.

Relating to the presentation of interest expense

60 An entity shall recognise in profit or loss:

...

- (h) unless paragraph 66 applies, interest expense on insurance contract liabilities determined using the discount rates specified in paragraph 25 that applied at the date that the contract was initially recognised. For cash flows that are expected to vary directly with returns on underlying items, the entity shall update those discount rates when it expects any changes in those returns to affect the amount of those cash flows.

66 If an entity applies paragraphs 33–34 because the insurance contract requires the entity to hold underlying items and specifies a link to returns on those underlying items, an entity shall recognise:

- (a) changes in the fulfilment cash flows that result from applying paragraphs 33–34 in profit or loss or other comprehensive income on the same basis as the recognition of changes in the value of the underlying items;
- (b) changes in the fulfilment cash flows that are expected to vary indirectly with those returns on underlying items in profit or loss; and
- (c) changes in the fulfilment cash flows that are not expected to vary with those returns on underlying items, including those that are expected to vary with other factors (for example, with

mortality rates) and those that are fixed (for example, fixed death benefits), in profit or loss and in other comprehensive income in accordance with paragraphs 60–65.

Relating to disclosure

- 80 If an entity applies the requirements of paragraphs 33–34 and 66 to insurance contracts that require the entity to hold underlying items and specify a link to returns on those underlying items:
- (a) the entity shall disclose the amounts in the financial statements that arise from the cash flows to which the entity has applied paragraphs 33–34 and 66; and
 - (b) if the entity discloses the fair value of underlying items that are measured on a basis other than fair value, it shall disclose the extent to which the difference between the fair value and the carrying amount of the underlying items would be passed on to policyholders.

Relating to the mirroring exception

- 33 An entity shall apply paragraph 34 if the contract:
- (a) requires the entity to hold underlying items such as specified assets and liabilities, an underlying pool of insurance contracts, or if the underlying item specified in the contract is the assets and liabilities of the entity as a whole; and
 - (b) specifies a link between the payments to the policyholder and the returns on those underlying items. The entity shall determine whether the contract specifies a link to returns on underlying items by considering all of the substantive terms of the contract, whether they arise from a contract, the law or regulation.
- 34 When paragraph 33 applies, the entity shall, at initial recognition and subsequently:
- (a) measure the fulfilment cash flows that are expected to vary directly with returns on underlying items by reference to the carrying amount of the underlying items (meaning that paragraphs 18–27 do not apply); and
 - (b) measure the fulfilment cash flows that are not expected to vary directly with returns on underlying items in accordance with paragraphs 18–27. Such cash flows include fixed payments specified by the contract, options embedded in the insurance contract that are not separated and guarantees of minimum payments that are embedded in the contract and that are not separated in accordance with paragraph 10.
- B83 Paragraph 34 specifies requirements that eliminate accounting mismatches between the cash flows from an insurance contract and underlying items when the terms of the contract mean that the entity will not suffer any economic mismatches. That is the case when the criteria in paragraph 33 are met, ie when the contract specifies a link to those underlying items.
- B84 The criteria in paragraph 33 would not be met if either of the following apply:
- (a) the payments arising from the contract reflect the returns on identifiable assets or liabilities only because the entity chooses to make payments on that basis. In that case, the entity may choose to avoid economic mismatches by making payments that are expected to vary directly with returns on underlying items, but it is not required to do so. However the entity is not required to avoid the economic mismatches that would arise if it held other assets or liabilities.
 - (b) the entity could choose to hold the underlying items and so could avoid the economic mismatches, but is not required to hold those underlying items.
- B85 For contracts meeting the criteria in paragraph 33, an entity determines the fulfilment cash flows that are expected to vary directly with returns on underlying items and measures those fulfilment cash flows on a different basis from the other fulfilment cash flows. An entity shall decompose the cash flows in a way that maximises the extent to which the measurement both:

- (a) expresses the cash flows in a way that illustrates the extent to which they are expected to vary with returns on underlying items; and
- (b) maximises the minimum fixed payment that the policyholder will receive.

B86 For example, if a contract promises to pay a policyholder a minimum of CU1,000 plus 90 per cent of the increase in the fair value of underlying items ('A') above an initial fair value of CU1,000, the cash flows could be decomposed in the following ways:

- (a) as a fixed amount plus a written call option, ie
 $CU1,000 + [90\% \times \text{the greater of } (A - CU1,000) \text{ and } CU0]$;
- (b) as 100 per cent of the assets plus the value of the guarantee (a written put option) less the value of the entity's 10 per cent participation in the upside (a call option held), ie
 $A + [\text{the greater of } (CU1,000 - A) \text{ and } CU0] - [10\% \times \text{the greater of } (A - CU1,000) \text{ and } CU0]$; or
- (c) as 90 per cent of the assets plus a fixed payment of CU100 plus 90 per cent of the increase in the assets above CU1,000, ie
 $[90\% \times A] + CU100 + [90\% \times \text{the greater of } (CU1,000 - A) \text{ and } CU0]$.

However, only (c) would meet the conditions in paragraph B85 because it expresses the cash flows in a way that maximises the extent to which they are expected to vary with returns on underlying items, and the minimum fixed payment the policyholder will receive.

B87 The general requirements in paragraphs 60–65 for presentation in profit or loss or other comprehensive income would not apply to those cash flows that are expected to vary directly with returns on underlying items. However, the entity would apply the requirements in paragraphs 60–65 to the cash flows in contracts that are not expected to vary with returns on underlying items.

From the Basis for Conclusions

To avoid undue length, the staff has not reproduced extracts of the Basis for Conclusions relating to participating contracts. The following table provides references to the appropriate sections of the Basis for Conclusions

| Topic | Relevant paragraphs in the Basis for Conclusions |
|---|---|
| Separating components from an insurance contract | BCA189-BCA208 |
| Adjusting the contractual service margin by changes in the carrying amount of underlying items | BC38-BC41 |
| Cash flows that are expected to vary with returns on underlying items | BC42-BC44 BCA58-BCA63 |
| Discount rate when cash flows depend on assets | BCA84-BCA88 |
| The mirroring exception: Contracts that require the entity to hold underlying items and specify a link to returns on those underlying items | BC45-BC50 |
| Changes in value of options embedded in insurance contracts | BC51-BC53 |
| Complexity from the need to decompose cash flows | BC56-BC62 |
| Alternative proposals for scope of mirroring exception | BC63-BC71 |
| Determining interest expense in profit or loss: applying general model | BC117-BC124 |
| Determining interest expense in profit or loss: in the mirroring exception | BC125-BC132 |
| Identifying assets that back insurance contracts | BC146-BC147 |
| Using a book yield to determine interest expense | BC158-BC159 |

STAFF PAPER

19-23 May 2014

REG IASB Meeting

| Project | Insurance contracts | | |
|-------------|--|--|----------------------|
| Paper topic | Possible adaptations for contracts with participating features | | |
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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. A contract with a participating feature is one in which the policyholder shares with the entity some of the risk from underlying items. Examples of underlying items include:
 - (a) a share in a pool of assets (notional or actual);
 - (b) an interest return on an explicit account balance (ie a nominal amount);
and
 - (c) a share in the performance of a pool of insurance contracts.
2. In other words, the defining feature of a contract with a participating feature is that the contract provides the policyholder with an investment return that varies with the overall returns on the underlying items. This means that the policyholder bears some of the investment risk. For contracts with no participating features, the entity bears all of the investment risk.
3. This paper discusses whether adaptations for contracts with participating features are needed to be made to the IASB's previous decisions for contracts with no participating features and if so, what those adaptations are.

4. The paper describes:
 - (a) what the IASB's tentative decisions for contracts with no participating features are; and
 - (b) the adaptations that the IASB could consider for contracts with participating features, including:
 - (i) the adaptations that the IASB proposed in the 2013 Exposure Draft *Insurance Contracts* (2013 ED); and
 - (ii) the alternative adaptations proposed in the comment letters.
5. This paper includes limited discussion of the mirroring exception proposed in the 2013 ED for a narrow set of contracts with participating features. Instead, the paper focuses on possible adaptations to the general model developed by the IASB. The staff plan to consider at a later stage whether an exception such as the mirroring exception would still be needed.
6. This paper does not ask the IASB for decisions. The staff intend to ask for decisions on contracts with participating features at a future meeting. This paper should be read in conjunction with Agenda Paper 2A *Background on contracts with participating features*.

Structure of the paper

7. The analysis in this paper considers the general model developed by the IASB to date, and considers the adaptations that might be needed for contracts with participating features in respect of the following:
 - (a) measuring the fulfilment cash flows (paragraphs 8-20);
 - (b) measuring the contractual service margin (paragraphs 21-49);
 - (c) recognising changes in estimates (paragraphs 50-77); and
 - (d) presentation in the statement of comprehensive income (paragraphs 78-98).

Measuring the fulfilment cash flows

8. The 2013 ED proposes that the measurement of a contract with participating features is the present value of the fulfilment cash flows determined using a discount rate that reflects the characteristics of those cash flows. At initial recognition and subsequently, the fulfilment cash flows are defined as an explicit, unbiased and probability-weighted estimate (ie expected value) of the present value of the future cash outflows less the present value of the future cash inflows that will arise as the entity fulfils the insurance contract, including a risk adjustment. The underlying objective of this approach is to achieve a valuation of the insurance contract, including any options and guarantees embedded in the insurance contract, in a manner that is consistent with market information.
9. The 2013 ED did not propose particular adaptations for the fulfilment cash flows in contracts with participating features, but provided application guidance on how to apply the principles in the general model to contracts with participating features. This section discusses that application guidance, as follows:
 - (a) cash flows (paragraphs 10-12);
 - (b) discount rate (paragraph 13);
 - (c) risk adjustment (paragraph 14); and
 - (d) the interaction between the cash flows and the discount rate (paragraphs 15-20).

Cash flows

10. For contracts with participating features, the cash flows that arise as the entity fulfils the contract include the following:
 - (a) cash flows that vary with returns on underlying items, either directly or indirectly. These are cash flows that provide the policyholder with a return on underlying items. These cash flows include:
 - (i) cash flows that arise because of a direct correlation between the returns on underlying items and the returns to

policyholders (ie the cash flows vary directly with returns on underlying items); and

- (ii) cash flows that vary with returns on underlying items only when the returns from the underlying items exceed the floor (ie the cash flows vary, but indirectly with the returns on underlying items).

The 2013 ED referred to the cash flows that vary directly and indirectly with returns on underlying items. This paper uses the term ‘cash flows that vary with returns on underlying items’ to include both those that vary directly or indirectly. Such cash flows arise only in contracts that have participating features.

- (b) cash flows that do not vary with the returns on underlying items. These cash flows arise when the amount paid to the policyholder does not change because there is a change in the performance of the pool of underlying items. Such cash flows include:

- (i) claims handling costs (ie the costs that the entity will incur in processing and resolving claims) and other expenses. Such cash flows also arise in contracts that have no participating features.
- (ii) fixed amounts that would be paid out on the occurrence of an insured event. The 2013 ED termed these ‘cash flows that do not vary with underlying items’. Such cash flows also arise in contracts that have no participating features.
- (iii) a fixed amount paid in all scenarios (ie a floor). For example, some insurance contracts contain embedded guarantees (for example, a guarantee that promises a minimum investment return). Such cash flows arise in some contracts that have participating features and contracts that have no participating features (for example, endowments).

- 11. Consistent with the principle that the measurement of the insurance contract includes all the cash flows that arise as the entity fulfils the contract, the 2013 ED provided application guidance that the cash flows used to measure the contract include:

- (a) cash flows that will result from options and guarantees embedded in the contract, to the extent that those options and guarantees are not separated from the insurance contract (see paragraph 10(a) of the 2013 ED). The 2013 ED also clarified that when insurance contracts contain embedded options or guarantees, it is important to consider the full range of scenarios (see paragraph B66(f) of the 2013 ED).
 - (b) payments arising from existing contracts that provide policyholders with a share in the returns on underlying items (see paragraph 33 of the 2013 ED), regardless of whether those payments are made to current or future policyholders (see paragraph B66(k) of the 2013 ED).
12. The 2013 ED also clarified that the cash flows used to measure the insurance contract exclude investment returns on underlying items. The investments are recognised, measured and presented separately. However, if any cash flows of the insurance contract depend on the investment returns, the measurement of that insurance contract may be affected (see paragraph B67(a) of the 2013 ED).

Discount rate

13. The 2013 ED did not propose any adaptations to the principle that estimates of discount rates should be consistent with other estimates that are used to measure the insurance contract in order to avoid double counting or omissions. However, it clarified that the characteristics of the insurance contract should reflect the extent of dependence of the amount, timing or uncertainty of the cash flows that arise from the insurance contract on the returns on underlying items. The discount rate used to measure those cash flows shall therefore reflect the extent of that dependence. Paragraphs 15-20 describe the concerns that were raised because of the way the 2013 ED described how this principle could be implemented.

Risk adjustment

14. The 2013 ED did not propose any adaptations for contracts with participating features with respect to the risk adjustment, and the staff believes that none are needed.

Overall measurement of fulfilment cash flows: interaction between the cash flows and the discount rate

15. The 2013 ED described one way of achieving the objective of the 2013 ED by measuring the fulfilment cash flows by dividing the cash flows of the contract and applying different discount rates, as follows:
- (a) For cash flows that vary with underlying items, the underlying items are likely to include assets (perhaps exclusively). Thus, the appropriate discount rate is the rate that reflects the extent of that dependence with the assets. Hence, the rate is likely to include asset risk that is shared with the policyholder.
 - (b) For cash flows that do not vary with underlying items, the policyholder does not share in the asset risk. Thus, the appropriate discount rate should not include any asset risk. Therefore, it is likely that this would be a lower discount rate than the rate applied for the cash flows in (a).
16. In other words, the approach in the 2013 ED seeks to value the insurance contract, including any guarantees embedded in the insurance contract, in a manner that is consistent with market information by placing weight on the appropriate discount rate for each set of cash flows.
17. For example, a guarantee of fixed amount on death (for example, CU100,000¹) could be embedded in a contract with participating features. The same guarantee could also be embedded in a contract with no participating features. The IASB's objective was that there would be consistent measurement of the fulfilment cash flows of that guarantee regardless of the contract that the guarantee was embedded in. Because the guarantee does not vary with underlying items, the appropriate discount rate is the discount rate that is not asset dependent. However, if the entity applied a discount rate that reflected the dependence of the cash flows of the guarantee on the underlying assets (Discount 1), the probability-weighted estimate of cash flows of the guarantee would be lower than that determined using a discount rate that has no dependence on the assets (Discount 2). Consequently, if the entity applied Discount 1 to the fulfilment cash flows of the guarantee, the

¹ In this Staff Paper, currency units are denominated in "currency units" (CU).

entity would need to do further adjustments in the valuation so that the guarantee is measured appropriately to increase the estimate of the liability.

18. The 2013 ED's objective could be achieved with a "real-world" and "risk-neutral" approach for valuing the insurance contract.² However, some interpreted the 2013 ED as precluding use of one of these two approaches.
19. Many constituents thought that the 2013 ED was too prescriptive in specifying the use of the divide and measure the cash flows approach, which was discussed in paragraph 15, to achieve the objective of market-consistent valuation. They note that there are other actuarial techniques to value a contract when the cash flows behave differently in various scenarios. They also thought that the approach would be too complex because:
 - (a) entities' systems typically use a single yield curve to discount all the cash flows of the portfolio of contracts. A single yield curve can achieve the objective of market consistent valuation if:
 - (i) An appropriate yield curve is chosen that reflects the characteristics of all the cash flows; and
 - (ii) An illiquid risk-free yield curve is applied to cash flow scenarios in which the probabilities of future outcomes are adjusted for risk (ie a "risk-neutral" approach).
 - (b) for valuing a minimum guarantee as described in paragraph 15, there would need to be a different division of cash flows every time there was a change to the guarantee. For example, some products provide a minimum amount that can be withdrawn at maturity or death and that minimum amount increases over the life the product.
20. The staff agrees that the IASB's objective could be met using actuarial techniques that use a single yield curve to estimate fulfilment cash flows, even when the

² Risk-neutral scenarios use probabilities of future outcomes that are adjusted for risk, and the probability-weighted cash flows are then discounted using the risk-free rate. Real-world scenarios use probabilities of future outcomes that are not adjusted for risk, and the probability-weighted cash flows are then discounted using a discount rate that includes the risk premia that market participants require for bearing risk. In other words, risk is reflected for risk-neutral scenarios within the probabilities, and for real-world scenarios within the discount rate. Both approaches can be used for the market-consistent valuation of assets and liabilities, if care is taken to reflect the risk premia that market participants require.

contract includes both cash flows that vary and those that do not with underlying items. However, the staff thinks that dividing the cash flows into cash flows that vary, and those that do not, with underlying items and applying appropriate discount rates to each may still be needed to provide consistency in:

- (a) the measurement of the contractual service margin, and therefore, of the total liability. The discount rate affects the amount of interest accreted on the margin and the amounts that adjust margin (which are determined on a present value basis). The staff plan to consider at a future meeting the discount rate that should be applied when accreting and adjusting the margin.
- (b) the presentation of interest expense. When an entity chooses to present the effects of discount rate changes in OCI, the discount rate affects the amounts recognised in other comprehensive income (OCI) and profit or loss. This is discussed further in paragraphs 85-97.

Question 1— Measuring the fulfilment cash flows

Do you have any comments or questions on the staff's analysis about the measurement of the fulfilment cash flows?

Measuring the contractual service margin

- 21. This section discusses, for the contractual service margin:
 - (a) the adaptations that the IASB proposed in the 2013 ED for contracts with participating features in paragraphs 23-26;
 - (b) an alternative proposal for adaptations for contracts with participating features, which include proposals relating to:
 - (i) the entity's share in the underlying items in paragraphs 27-44;
 - (ii) the recognition of the margin in profit or loss in paragraphs 45-48; and
 - (c) further adaptations that may be needed in paragraphs 49-22.

22. The other sections of the paper also discusses whether the margin should be adjusted for:
- (a) changes in estimates of investment returns that result in changes in the amounts paid to policyholder (paragraphs 50-56); and
 - (b) changes in options and guarantees (paragraphs 57-77).

The adaptations that the IASB proposed in the 2013 ED

23. Contracts with participating features are predominantly investment contracts that oblige the entity to provide asset management services in addition to insurance coverage. The IASB’s tentative decisions on unbundling goods and services mean that some of these asset management services would not be unbundled because they are integrated with the insurance coverage.
24. The 2013 ED acknowledged that the services in a contract with participating features include insurance coverage and asset management and, as a result, the 2013 ED required that an entity recognise the margin in profit or loss in the pattern of transfer of “coverage and other services”. It was envisaged that “other services” would encompass asset management services. The IASB has previously concluded that a reasonable pattern of profit recognition for asset management services would be one that tracks the build-up of the assets over time.
25. Because the margin is a blend of insurance coverage and asset management services that are not separately identifiable, any recognition pattern for the contractual service margin is inevitably arbitrary, at least to some extent. The staff thinks that to apply the requirement that an entity recognises the margin in profit or loss in the pattern of transfer of coverage or other services:
- (a) the entity would choose the predominant driver that best reflects the pattern of transfer of the combined coverage and asset management services and then recognise the margin in profit or loss over the coverage period. A profit driver based on assets under management may be appropriate when the principal service provided is investment management.

- (b) depending on the contract, it may be appropriate to change the profit driver from asset management services to insurance coverage (or vice versa) over time. For example, in a product with a guaranteed annuity option, the entity provides asset management service prior to the option being exercised and insurance coverage after the option is exercised.

26. Contracts that provide asset management service also provide an investment return. The proposals in the 2013 ED reflect the IASB's view that the provision of investment returns to the policyholder is not a service. Instead it is a financial return. Thus, because the IASB views the contractual service margin as the unearned profit from the contract that would be earned from providing services under the contract, the contractual service margin would not be recognised in profit or loss in a pattern that reflects expected investment returns or expected realisation of investment returns. The 2013 ED further clarified that:

- (a) the contractual service margin is not adjusted for changes in estimates of cash flows that depend on investment returns if those changes arise as a result of changes in the value of the underlying items. Such changes do not relate to services provided under the contract. That means that an entity does not adjust the margin by changes to the estimates of payments to policyholders (see paragraph B68(d) of the 2013 ED).
- (b) the contractual service margin is adjusted for changes in estimates of cash flows that are expected to vary directly with returns on underlying items only if those cash flows relate to future services under the insurance contract. For example, changes in cash flows due to the effect of changes in explicit asset management fees relate to future services under the insurance contract. Gains or losses on the underlying items do not relate to unearned profit from future services from the insurance contract and are recognised in accordance with the Standards relevant to the underlying items.

Alternative adaptations proposed

27. In the comment letters to the 2013 ED, some preparers suggested an alternative proposal for the measurement of the contractual service, which is discussed in the paragraphs below ('the alternative proposal').
28. The alternative proposal reflects a difference in view between its proponents and the view in the 2013 ED, as follows:
- (a) the IASB views the contractual service margin as the unearned profit from the contract that would be earned from providing services under the contract. In effect the IASB's view regards the contractual service margin as the representation of an obligation measured at the amount of profit that the entity expects to receive for fulfilling the obligation. The IASB does not view the provision of investment returns as a service.
 - (b) The proponents of the alternative proposal view the margin as unearned profit for the entity arising from the insurance contract. They view the performance of the underlying items as integral to the overall performance of the contract. Consequently, the margin on Day 2 should represent unearned profit that includes any gains and losses from the underlying items recognised in accordance with other Standards that they believe have not yet been earned. Proponents of the alternative proposal regard the provision of investment returns as a service.
29. Are these two views different? On Day 1, the two views have the same effect. However, this difference in views would result in different effects on Day 2 in two important aspects:
- (a) the treatment of the entity's share of returns on the underlying items:
 - (i) In the 2013 ED proposals, the margin is adjusted for gains and losses that relate to future service within the boundaries of the contract's cash flows.
 - (ii) In the alternative proposal, the margin is adjusted for gains and losses arising from the changes in entity's share of the underlying items (for example, assets, experience) to which

the participating contract is linked. This is discussed further in paragraphs 27-44.

- (b) the recognition of the contractual service margin in profit or loss
 - (i) In the 2013 ED proposals, the margin is earned according to the pattern of insurance coverage or other service (for example, asset management service).
 - (ii) in the alternative proposal, for some contracts the margin is earned when profits from the insurance contract are considered attributable to the entity, as described in paragraph 30.

30. Paragraph 29(b)(ii) described the recognition of the margin in profit or loss under the alternative proposal as being earned when profits from the insurance contract are considered to be attributable to the entity. Under this proposal, the profit driver for the services provided would depend on both the contractual features of the contract and the regulatory environment:

- (a) in some contracts, there is a contractual or regulatory performance-sharing mechanism. In such cases, the recognition of the margin in profit or loss would be consistent with the performance-sharing mechanism between the policyholder and the entity. Proponents of the alternative proposal believe that the entity's share of profits arises when amounts are attributed to the policyholder (ie when bonuses are declared or amounts are credited to the policyholder's account). They believe that the entity's share that relates to such amounts represents the earned profit from providing services under the contract. In general, the performance-sharing mechanisms between policyholders and the entity:
 - (i) are meant to reflect the risk shared by both parties;
 - (ii) are capable of increasing the value of the guarantees written by the entity to the policyholder; and
 - (iii) may be constrained by regulation or competitive forces, or both, to differing extents.

This is discussed further in paragraphs 31-44.

- (b) in some cases, the contract provides only a fee to the entity. In such cases, the recognition pattern is based on the fees charged in the period. This is discussed further in paragraphs 45-48.

31. For contracts that have a contractual or regulatory performance-sharing mechanism, the alternative proposal contains two variations for determining the amount of the margin to be recognised in profit or loss in the period. Both variants are intended to ensure that the carrying value of the margin represents the profits from the contract that are not yet considered attributable to the entity (for example, the value of future bonuses to the entity). The amount recognised in each period would reflect the change in those amounts (for example, the change in the value of bonuses), because the proponents of the alternative proposal regard the provision of such amounts as the service provided under the insurance contract in the period. Assuming no guarantees and options, the two variations proposed are:

- (a) **Variation 1:** the total net profit recognised from the changes in the underlying assets and the insurance liability, including the margin, equals the profit that is considered to have become attributable in the period and the carrying value of the margin represents the value of future attributable profits. This method is consistent with an approach currently used in some jurisdictions in which the amount recognised in profit or loss is the bonus declared to the entity in that period, and the value of future bonuses is treated as part of the liability.
- (b) **Variation 2:** the carrying value of the margin at the end of the period is measured directly by calculating the present value of the entity's share of future attributable profits. Consequently, the amount of contractual service margin recognised in each is the difference between the previous carrying value of the margin and the directly determined present value of entity's share of future attributable profits.

32. The following simplified example illustrates the alternative proposal and these differences for a simplified discretionary 90/10-style participating contract. The assumptions are simplified to illustrate how the gains or losses potentially attributable to the entity would adjust the margin. The example also ignores options and guarantees.

Example 1: alternative proposal

A portfolio of contracts with participating features was written at the beginning of the year, in which:

- the entity received premiums totalled CU1,000, which was used to purchase assets;
- the policyholder participates in 90% and the entity in 10% of the asset returns; and
- the expected present value of the cash outflows is CU900 and the margin is CU100.

At the end of the year:

- the entity attributes profits by declaring a bonus of CU45 to the policyholders and CU5 represents the entity's share (total bonuses declared are CU50); and^{3,4}
- the underlying assets have grown to CU1,100 (an increase of CU100).

As a simplifying assumption, the amounts recognised in profit or loss for the change in the insurance liability is CU90 (90% X 100[increase in the value of the assets]) and this is the same under both the 2013 ED and alternative proposal.

Under the 2013 ED proposal:

- The margin recognised in profit or loss in line with services is CU7 (assumption).
- The net profit is a sum of the investment margin for the period and the recognition of the margin in profit or loss.
- The liability at the end of the year is CU1,083 which represents all the performance obligation of the contract. This comprises the fulfilment cash flows of CU990 (CU900+CU90) and the margin of CU93 (CU100-CU7). CU93 represents the performance obligation for services to be provided.

The profit or loss for the period would be as follows (ignoring the accretion of

³ For some contracts, the bonuses declared are typically unrelated, or only incidentally related, to the short-term fluctuations in asset returns arising in the reporting period.

⁴ For some contracts, the performance-sharing mechanism would determine the ratio of entity to policyholder bonuses. For other contracts, the entity may have some or full discretion on determining that ratio.

| | | |
|--|---|----------------------|
| interest on the margin): | | |
| | ED proposal | Alternative proposal |
| Insurance contract revenue | 7 | 5 |
| Investment income | 100 | 100 |
| Interest expense | (90) | (90) |
| Net investment margin | 10 | 10 |
| Remeasurement of the margin | | (10) |
| Net profit | 17 | 5 |
| | The liability recognised on the balance sheet is: | |
| Liability | 1,083 | 1,095 |
| Under the alternative proposal: | | |
| <ul style="list-style-type: none"> • Gains/losses potentially attributable to the entity of CU10 (CU100[Investment income]–CU90[Policyholder’s share in investment income recognised in profit or loss]) would be adjusted against the margin. • CU5 of the margin would be recognised in profit or loss, representing the entity’s view of the services provided in the period. This example assumes that the shareholder’s bonus represents the services provided in the period. • As a consequence, net profit considering both the underlying items and the liability is CU5, which represents the entity’s view of the services provided in the period. • The liability at the end of the year is CU1,095. This is comprised of the fulfilment cash flows of CU990 (CU900+CU90) and the margin of CU105 (CU100+CU10-CU5). | | |

33. In effect:

- (a) **For the entity’s share:** the alternative proposal reflects the view that the entity does not earn investment gains and losses in the period. Accordingly, the proposal would adjust the contractual service margin for the entity’s share of the investment income or losses arising from the underlying items that are recognised in profit or loss. For example, the proposals would mean:

- (i) For debt instruments accounted for at Fair value through OCI (FVOCI), the impairment losses and interest revenue recognised in profit or loss would adjust the margin. However, the fair value gains and losses recognised in OCI would not adjust the margin.
- (ii) For assets accounted for at fair value through profit or loss (FVPL), the fair value gains and losses would adjust the margin.

(In Example 1, the gain of CU10 potentially attributable to the entity is treated as an adjustment to the margin.) Paragraphs 34-44 discuss the arguments for and against this approach further.

- (b) **For the recognition of the margin in profit or loss:** the alternative proposal applies a driver to recognise the margin in profit or loss in a way that reflects the profits are attributable to policyholders (for example, that reflects the declared bonuses). In example 1, the driver for the recognition of the margin in profit or loss is the entity's share in declared bonuses. The recognition of the margin in profit or loss is determined so that it achieves a net profit recognised that is equal to the CU5 that the entity regards as earned for the services provided in the period. Paragraphs 45-48 set out the arguments for and against this approach for recognition of the margin.

Should the margin be adjusted with changes in the entity's expected profit from the underlying items?

- 34. Reasons given by supporters of the proposal to adjust the contractual service margin by changes in estimates of the entity's expected profit from the underlying items are:
 - (a) the entity's share in the performance of the underlying items provides one of the sources of profits for the participating business. In other words, one of the sources of profit is the spread difference between the performance of the underlying items and the performance promised to the policyholder.

- (b) the entity's share in the performance of the underlying items is akin to an implicit asset management fee. Changes in the effect of explicit asset management fees related to future services would adjust the margin according to the proposals in the 2013 ED.
- (c) some note that adjusting the margin for the entity's expected profit from underlying items would result in a net profit or loss that would be the same regardless whether the changes in discount rates are recognised in profit or loss or OCI. Accordingly, they suggest that it would not be necessary to require/permit the use of other comprehensive income for the recognition of the effects of changes in market variables (or other items).

35. However, arguments against adjusting the contractual service margin by changes in estimates of the entity's expected profit from the underlying items are as follows:

- (a) It would be inconsistent with the approach for contracts with no participating features (see paragraph 36);
- (b) It would be inconsistent with other IFRS (for example, IFRS 9 *Financial Instruments* (IFRS 9)) (see paragraph 37);
- (c) It would require the identification of the underlying items (see paragraphs 38-41); and
- (d) It may have similar disadvantages to those reported in the comment letters relating to the mirroring exception (see paragraphs 42-44).

These arguments are discussed below.

Consistency with contracts with no participating features

36. Some disagree that the margin should be adjusted to reflect the changes in entity's share of the underlying items on the grounds that this is a source of profits for contracts with participating features. This is because the investment returns on underlying items acquired with premiums from an insurance contract are also a source of profit for the entity in some, if not all, of non-participating insurance contracts. The only difference is that the policyholder is promised an obligation

that does not vary with the performance of the underlying items. Consequently, treating the investment returns arising from assets that back contracts with participating features differently from returns arising from assets that back contracts with no participating features could be regarded creating an arbitrary difference in the way insurance contracts are accounted for. Those that hold this view do not see the changes in entity's share of the underlying items as an implicit asset management fee.

Consistency with other IFRSs

37. Some disagree that the margin should be adjusted to reflect the changes in entity's share of the underlying items because they view the proposals to be inconsistent with the requirements of other IFRSs. They note that the entity's share in the performance of the underlying items is a consequence of the entity controlling the underlying items and having to recognise those underlying items in the balance sheet and profit or loss in accordance with IFRSs. Consequently, they think it is inconsistent with IFRSs to change the timing of when these income and expenses of the underlying items are recognised in profit or loss so that they would be significantly different from how such underlying items would be accounted for if they did not back insurance contracts with participating features. They note that such inconsistencies increases structuring opportunities and, therefore, may reduce the transparency of the results between economically similar transactions.

Need to identify underlying items

38. Some note that a fundamental difficulty with the proposal to adjust the margin to reflect the entity's share of the underlying items is that it would require the IASB to specify which underlying items would qualify. However, identifying such criteria would be difficult, because :
- (a) in some cases, there is a clear linkage between the returns to policyholders and the underlying items. This is the case when the contract or regulation specifies that the entity must hold the specified underlying item and when the contracts permits the entity no discretion over the amount and timing of the returns passed to the policyholder. An example of a contract in which there is clear linkage is a unit-linked

contract with a legally segregated fund of assets. For most of these contracts the entity will charge an explicit fee. Some entities also hold a share in the underlying items in the form of units of those funds. How should the entity's direct holding of the units be treated?

- (b) in some jurisdictions, the regulation or law requires the underlying items for some contracts to be held separately from the rest of the entity's assets and liabilities. However, there are variations in the performance-sharing mechanism. The entity may be obliged to pass on a specified return or may have some or full discretion on the amount and/or timing of the returns passed to the policyholder. It can be difficult to identify when cash flows reflect a share in underlying items, rather than a payment made at the entity's discretion that does not reflect a share in the underlying items.
- (c) for some contracts, the designation of underlying items may exist only for internal management purposes. This could create the following difficulties:
 - (i) the entity may change those designations for various reasons.
 - (ii) 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.
- (d) the entity could promise a return based on a specific type of underlying items and could choose to invest the premiums in money collected that was not solely in specified type of 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 what the underlying items are in this case.
- (e) there may be no assets designated but 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 could be unclear what the underlying items are.

39. The difficulty in specifying underlying items was also illustrated in the response to the proposed mirroring exception in the 2013 ED. The mirroring exception applied only to contracts with participating features for which there could be no possibility of an economic mismatch between the returns on underlying items and payments to the policyholder. The 2013 ED proposed that, to qualify for this exception to the general model, an entity must hold underlying items and the contract must specify a link between the payments to the policyholder and the returns on those underlying items. Many disagreed with the scope of the proposals but for various reasons:
- (a) Some would have restricted the scope further to where there was also a contractual link to specified amounts paid to the policyholder because they thought that the proposals were too difficult to be applied to contracts in which there are discretionary payments.
 - (b) 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.
40. The staff also note that the difficulty in specifying the underlying items was one of the considerations in the staff recommendation for an accounting policy option for presenting the effects of discount rate changes in profit or loss or other comprehensive income instead of specified criteria related to the assets backing the portfolio of contracts. In the feedback on providing an option of the proposals, entities noted that some 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 likely not to exist in the population of the existing insurance contracts.

41. If the IASB concluded that the challenges of identifying underlying items could be overcome, it would also need to consider the following issues:
- (a) Would there be a need to mitigate any structuring opportunities between contracts that qualify and those that do not? The significance of such opportunities would increase with the degree of difference between the proposals for contracts with participating features from the proposals for contracts with no participating features. It could be possible to address this issue using strict and objective criteria for determining which contracts should be accounted for as having participating features.
 - (b) Would there be a need to mitigate any complexity for entities that do not identify underlying items in the way specified?

Relevant feedback from the mirroring exception

42. There are similarities between the alternative proposal and the mirroring exception because the insurance liability could comprise components measured using a combination of different accounting bases:
- (a) under the mirroring exception, the component is the fulfilment cash flows.
 - (b) under the alternative proposal, the component is the margin.
43. Accordingly, the staff note this criticism of the mirroring exception, 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 may not be understandable to users, could also apply to the alternative proposal. Under the alternative proposal, the margin would be measured as a total of the amounts measured using different measurement basis (for example, fulfilment cash flows, amortised cost, fair value gains or losses).
44. In addition, the implementation of the mirroring exception requires entities to track the amounts reported in the statement of comprehensive income (and the balance sheet) that are related to the underlying items so that the relevant amounts

for the liability could be determined. Some have told us that this would be too difficult. This complexity also applies to the alternative proposal.

Question 2—Entity’s share of underlying items

Do you have any comments or questions on the staff’s analysis of the need for adaptations to account for the entity’s share of underlying items?

In particular, do you have any comments or questions on the feasibility of identifying underlying items for contracts with participating features?

How should the margin be recognised in profit or loss?

45. Those in favour of recognising the contractual service margin in profit or loss according to the profits attributable to the entity argue that such profits are the best indication of the pattern of services provided:
- (a) for contracts with performance-sharing mechanisms, proponents of this view regard the provision of service to be the amounts paid under the performance-sharing mechanism.
 - (b) for fee-based contracts, proponents of this view believe that the explicit fee should be most indicative of the service provided.
46. However those who disagree that the contractual service margin should be recognised according to the profits attributable to the entity argue that such an approach may **not** be indicative of the pattern of services provided⁵. For example, the amounts paid under the performance-sharing mechanism would not be indicative of the pattern of services provided when:
- (a) the amounts attributed to policyholders are based on the timing of the realisation of the underlying items (for example, when interest is received from a bond). For example, in some cases a bonus is paid when the underlying item is sold. However, the service that the entity has provided is the asset management services of investing the policyholder’s fund appropriately and rebalancing the investments

⁵ The staff notes that if the bonuses are allocated in the same pattern as the estimate of the provision of services, the pattern of bonuses may be an acceptable proxy for the provision of services under the contract.

when needed. Such asset management services would be provided throughout the contract and not simply on the sale of the assets.

- (b) most of the asset returns are attributed on maturity of the contract. This would result in a greater recognition of the margin in profit or loss at the end of the contract, even though the policyholder benefits from the asset management and insurance services throughout the life of the contract.
- (c) when there are significant differences between the basis used for the performance-sharing mechanism and IFRS. For example, the performance-sharing mechanism calculates the amounts to be attributed using national GAAP requirements or according to solvency requirements.

47. Similarly, the pattern of charged explicit fees may not reflect the service provided in the period. This is the case when the fees do not follow the pattern of asset accumulation. For example, some contracts have explicit fees that are stepped (a different percentage or fee amount is charge in different periods). However, regardless of the pattern of fees charged, the same asset management services would be provided by the contract.

48. Thus the staff believe that recognising the contractual service margin in accordance with the amount attributable to the entity would not necessarily reflect the service provided under the contract. The staff think that a reasonable pattern for the recognition of the margin in profit or loss would reflect:

- (a) that the provision of services (for example, the asset management services and the insurance coverage) occurs over the life of the contract; and
- (b) that the total margin must be recognised in profit or loss in a reasonable, systematic way (for example, in the pattern of the build-up of the underlying assets on a fair value basis).

Question 3—Recognition of the margin in profit or loss

Do you have any comments or questions on the staff's analysis of the appropriate recognition pattern for the contractual service margin for contracts with participating features?

Further adaptations that may be needed

49. Staff note that, depending on the IASB's decisions on contracts with participating features on the margin (discussed in paragraphs 27-44), the IASB may need to consider whether further adaptations are needed relating to the following tentative decisions:
- (a) that, once the margin is exhausted, further changes in estimates of cash flows are recognised in profit or loss;
 - (b) that favourable changes in estimates that arise after losses were previously recognised in profit or loss should be recognised in profit or loss to the extent that they reverse losses that relate to coverage and other services in the future;
 - (c) that interest should be accretion interest on the margin; and
 - (d) on the appropriate discount rate used to accrete and adjust the margin.

Changes in estimates

Where should changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items be recognised?

The adaptations the IASB proposed in the 2013 ED

50. The 2013 ED proposed that changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items should be recognised in profit or loss. This is consistent with the recognition of changes in estimates of cash flows for financial instruments. For example, changes in estimates in

prepayment options for assets measured using amortised cost are recognised in profit or loss.

51. Feedback on this proposal was mixed:

- (a) a few recommended that all cash flows should be treated consistently and consequently, they believe that all changes in estimates should adjust the margin. This is discussed in paragraphs 53-54.
- (b) when the underlying items are measured at fair value through profit or loss, some supported the 2013 ED proposals to recognise the equivalent changes in the liability in profit or loss.
- (c) when the entity presents the effects of changes in discount rate in OCI, some thought that it would be more useful to recognise the equivalent changes in the liability in OCI. This is discussed in paragraphs 55-56.

52. Staff notes the difference between recognising changes in estimates as an adjustment to the margin, and recognising such changes in the statement of comprehensive income (ie profit or loss or OCI) is a difference in measurement and not presentation. This is because:

- (a) recognising the margin (as long as it is not zero) is that the total liability, and therefore, equity would **not** change in value before and after change.
- (b) recognising in the statement of comprehensive income (SCI), the total liability, and therefore equity, would change in value before and after the change.

Margin

53. Some note that it would be simpler to recognise changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items in a way that is consistent with the changes in estimates of other cash flows.

However, an argument against that proposal is that cash flows relating to the returns on underlying items do not represent a change in the profitability of the contract. For example, assume that the policyholder has a 100% of share in a known pool of assets. A change in the cash out flows due to changes in the

performance of the assets represents a change in the entity's obligation to pay out cash flows from the performance of the assets, rather than changes in estimates that relate to future services.

54. Furthermore, if those changes adjust the margin, this may result in less useful financial information because it may create an accounting mismatch between the returns the entity receives from the underlying items, and the amounts that the entity pays the policyholder. The following simplified example illustrates this issue when the underlying assets are measured at fair value through profit or loss and the contract provides the policyholder with 100% of the return of the underlying items:

Example 2 Changes in estimates of the returns on underlying items

At inception, the premium received is CU1,000. The entity uses CU950 to purchase a pool of assets and the fair value of the assets at inception is CU950 (assuming no transaction costs). The policyholder is promised 100% of the fair value of the assets on surrender or maturity. The margin at inception is CU50 (CU1,000-CU950).

After a year, the fair value of the pool of assets has decreased by CU7 from CU950 to CU943. Hence, the present value of fulfilment cash flows would also decrease by CU7.

To avoid accounting mismatch, the change in the present value of the fulfilment cash flows would be reported in the same way as the change in the fair value of the pool of assets. Consequently, the change in the present value of fulfilment cash flows should be reported in profit or loss consistent with fair value change in the assets with the following effect.

| | |
|---------------------------|-------|
| Fair value loss on assets | (CU7) |
| Gain on the liability | CU7 |

If the decrease in the fulfilment cash flows is recognised in the margin, an accounting mismatch would exist in profit or loss and on the balance sheet (because the total liability would remain at CU1,000 whereas the assets have changed to CU943).

Statement of comprehensive income

55. Some think that whether changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items are recognised in profit or

loss should be consistent with how the entity applies the accounting policy choice to present discount rate changes in profit or loss or OCI. (This assumes that the IASB will confirm that effects of discount rate can be recognised in OCI and extend the accounting policy option to contracts with participating features. This is discussed further in paragraph 79-84).

56. Some observe:

- (a) if the entity chooses to present the effects of changes in discount rates in profit or loss, recognising changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items would mean that the entity would present all the effects of changes in market variables in profit or loss (ie both changes in discount rate and estimates of cash flows). Presenting such changes in profit or loss would also be consistent with the recognition of changes in cash flows for financial assets.
- (b) if the entity chooses to present the effects of changes in discount rates in OCI, recognising changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items would allow consistency of recognition of changes caused by market variables. They argue that this would result in more useful information.

Question 4—Changes in estimates of investment returns that affect the amount paid to the policyholder

Do you have any comments or questions on the staff's analysis of the treatment of changes in estimates of investment returns that affect the amount paid to the policyholder?

Where should changes in the value of the options and guarantees be recognised?

57. When the policyholder receives 100% of the returns from underlying items, the appropriate accounting treatment for changes in returns from underlying assets is relatively straight-forward—most agree that changes in the liability should be

recognised in the same location as the underlying items. However, in most cases, contracts with participating features contain other features that will need to be accounted for—options and guarantees. Options and guarantees embedded in insurance contracts include, but are not limited to, derivatives as defined in IFRS. Some examples of those options and guarantees are included in Agenda paper 2A.

58. This section discusses:
- (a) the 2013 ED proposal and the feedback received in paragraphs 59-61;
 - (b) the components of an option and guarantee in paragraphs 62-68; and
 - (c) the alternatives for presenting options and guarantees in either the margin or SCI in paragraphs 69-77.

2013 ED proposal

59. The 2013 ED proposed that:
- (a) for contracts to which the entity applied the mirroring exception, changes in the fulfilment cash flows that are expected to vary indirectly with returns on underlying items would be recognised in profit or loss. Such cash flows would include those arising from the effect of market variables on the value of options and guarantees.
 - (b) for contracts to which the entity did not apply the mirroring exception, the 2013 ED did not have specific requirements on where the value of the cash flows that are expected to vary indirectly with returns on underlying items would be recognised. However, changes arising from changes in market variables would be recognised in the statement of comprehensive income: changes in estimates of the returns on underlying items would be recognised in profit or loss, and the effects of changes of discount rates would be recognised in OCI.

Feedback on the proposal to recognise options and guarantees in profit or loss under the mirroring exception

60. Some agreed with recognising options and guarantees in profit or loss because:

- (a) this would reduce an accounting mismatch when an entity economically hedges those options and guarantees with derivative instruments; and
- (b) the approach would be consistent with the treatment of derivatives in IFRS 9.

61. However, many disagreed with recognising options and guarantees in profit or loss because this was inconsistent with the proposals for contracts that did not apply the mirroring exception. They think that the IASB's decision that it would not separate these derivatives and account for them in accordance with IFRS 9 means that consistency with IFRS 9 should not be a primary driver. Instead:

- (a) Some think that there should be no separate requirements for options and guarantees consistent with contracts to which the entity did not apply the mirroring exception (discussed in paragraph 59(b)).
Consequently, there would be no need to separately recognise or present the valuation of options and guarantees from the determination of the fulfilment cash flows.
- (b) Some recommend that the proposals should be modified. However, these respondents had different views on whether the options and guarantees should instead be recognised in the margin or OCI (discussed in paragraphs 62-77).

What do we mean by changes in the value of options and guarantees?

62. The 2013 ED did not contain specific proposals for options and guarantees. However it envisaged that most of the cash flows arising from options and guarantees would be cash flows that varied indirectly with the returns on underlying items.
63. In practice, the phrase 'options and guarantees' is often used to refer to contractual features that produce pay-offs in some scenarios but not in others. These pay-offs include those that occur and those that do not occur on an insured event. An example is a guarantee of a specified minimum return to the policyholder, for example a guarantee of an annual return of at least 3% that is payable on death or at maturity. Guaranteed returns of this kind often provide

pay-off patterns that resemble those provided by explicit options, and are often valued using similar techniques.

64. There are two components in the valuation of options, which are:
- (a) Intrinsic Value—the difference between the market value of the underlying and the strike price; and
 - (b) Time Value—the present value of the difference between the market value of the underlying and the strike price in the future when the option is exercised.
65. When discussing whether the options and guarantees should be recognised in profit or loss, OCI or the margin, some respondents are **only** referring to the ‘time value of options and guarantees’⁶.
66. This may reflect that the time value of option and guarantees concept is part of one approach of the Embedded Value (EV) reporting framework. Some life insurers in some parts of the world report embedded value information, generally as supplementary, unaudited information outside the financial statements. Embedded value approaches have been largely unregulated and, as a result, there has been diversity in their application. In particular, some do **not** include a valuation of options and guarantees consistent with market information in their embedded value information.
67. Furthermore, the intrinsic value of the options and guarantees in embedded value approaches may not be calculated separately. Instead that value would be considered implicitly in the liability that is determined using best-estimate deterministic method⁷ (termed ‘deterministic best estimate liability (BEL)’). The entity then does another calculation of the liability using a stochastic method (termed ‘stochastic BEL’). The difference between the liability calculated using the deterministic and stochastic method is the time value of the options and

⁶ Sometimes called ‘time value of financial option and guarantees (TVFOG)’, ‘future options and guarantees (FIG), cost of future options and guarantees (CFOG), or similar name.

⁷ A deterministic model considers only one outcome. Stochastic models consider a range outcomes using either a mathematical formula or simulation techniques

guarantees. Those options and guarantees refer to those that pay out on an insured event and non-insured event.

68. Therefore, for practicality reasons, the staff has assumed that the IASB would not divide the change in value of options and guarantees into an element relating to cash flows and an element relating to the effect of discount rate changes, as would be the case if the general model were applied to such changes in estimates. As discussed in paragraph 59(b), some think that there should be no separate requirements for options and guarantees. But instead that the options and guarantees should be accounted for consistently with other features.

Should options and guarantee be recognised in the margin or in SCI?

69. Some think that the starting point of the analysis should be to see if options and guarantees could be presented consistently with the decisions for contracts that do not have participating features. However, changes in the value of these options and guarantees are a mixture of both changes in the estimates of cash flows and the effects of changes in the discount rate. Consequently, assuming that the IASB does not require entities to separate the cash flow and discount rate components for the reasons discussed in paragraphs 62-68, a valid case can be made for either recognising those options and guarantees in the margin or in SCI, depending on how the changes in the value of these options and guarantees are viewed.

Margin

70. Some argue that the value of these options and guarantees is considered in determining the margin on Day 1 and, therefore, that the changes in value of options and guarantees on Day 2 should adjust the contractual service margin. Proponents of that view believe that adjusting the contractual service margin for changes in the value of options and guarantees results in a better representation of the total unearned profit of the contract.
71. However, some support recognising changes in the value of options and guarantees as adjustments to the margin only because they do not support recognising those changes in OCI. They are concerned that the effects of options and guarantees may never be recognised in profit or loss.

72. Some that support recognising changes in the value of options and guarantees as adjustments to the margin would also support recognising changes in the value of the options and guarantees in profit or loss when the margin is exhausted. This is consistent with the IASB's decisions for contracts with no participating features. The staff note that the other alternatives discussed in paragraphs 31-44 on the measurement of the margin will either be affected when the margin is positive or rebuilt differently to a contract with no participating feature.
73. However, some that support options and guarantees as an adjustment to the margin would recommend another adaptation. They would recognise changes in estimates after the margin is exhausted in OCI instead of profit or loss.
74. One disadvantage of adjusting the contractual service margin for changes in the value of options and guarantees arises for entities that may choose to purchase derivatives as an economic hedge against their risk exposure from these options and guarantees. When that is the case, an accounting mismatch would arise in both the balance sheet and profit or loss when the changes in the options and guarantees are recognised against the margin because the value changes of these hedging derivatives are recognised in profit or loss. These economic hedges do not qualify for hedge accounting treatment under IFRS 9 and are not in the scope of the IASB's project on dynamic risk management.
75. The staff notes that hedging strategies differ. Some may hedge the risk exposure at the product type/portfolio level, others may hedge at an entity level. Most, if not all, entities do not fully hedge.

SCI

76. Some think that changes in the value of options and guarantees are similar to the effects of the changes in the discount rates that are recognised in the statement of comprehensive income or profit or loss. They believe that those options and guarantees do not relate to services and, therefore, that changes in the value of options and guarantees should not adjust the margin. They believe that the presentation of these changes in value should be consistent with the IASB's tentative decisions for contracts with no participating features— that the entity has an accounting policy choice to present effects of changes in discount rate in either

OCI, or profit or loss. (This assumes that the IASB will confirm that effects of discount rates can be recognised in OCI and extend the accounting policy option to contracts with participating features. This is discussed further in paragraphs 79-84). They believe that a consistent approach would be less confusing to users.

77. In addition, some note that recognising such changes in profit or loss or OCI (rather than as an adjustment to the margin) would:
- (a) provide better information because, at the reporting date, changes in the value of options and guarantees would be reflected in the total liability recognised and the net equity amounts on the balance sheet. When those changes in value are instead recognised in the margin, there is no impact in the financial statements unless the margin is no longer positive.
 - (b) avoid the issue of accounting mismatch when derivatives are used as an economic hedge against the exposure to embedded options and guarantees, while still enabling entities that did not hedge with derivatives to exclude such value changes from profit and loss (see paragraphs 74-74).

Question 5—Options and guarantees

Do you have any comments on or questions whether there should be specific requirements on options and guarantees?

If so, do you have any comments on how an entity should account for changes in the value of options and guarantees?

Presentation

78. This section discusses:

- (a) the presentation of interest expense (paragraphs 79-97); and
- (b) insurance contracts revenue (paragraph 98).

Presentation of interest expense

79. For contracts with no participating features, the IASB concluded at its meeting in March 2014 that:

- (a) when measurement inconsistencies do not result in a lack of faithful representation, it could be appropriate to measure financial assets at FVOCI or amortised cost and present the effect of changes in discount rates on the measurement of insurance contracts in OCI; and
- (b) it should allow entities to avoid accounting mismatches when they would result in financial statements that do not faithfully represent the reporting entity's financial position and performance by requiring that entities make an accounting policy choice whether to present the effect of changes in discount rates in either profit and loss or other comprehensive income.

80. In considering whether to extend these tentative decisions to contracts with participating features, the questions that arise are:

- (a) whether there are circumstances in which it would be appropriate to measure financial assets at FVOCI or amortised cost and present the effect of changes in discount rates on the measurement of insurance contracts in OCI for contracts with participating features; and
- (b) whether and how the IASB should allow entities to avoid any accounting mismatches that arise, if those accounting mismatches would result in financial statements that do not faithfully represent the reporting entity's financial position and performance.

81. In the feedback on the 2013 ED, some think that the proposals to present the effects of changes in discount rates in OCI:
- (a) is not suitable for contracts with participating features because of the variability of the cash flows caused by changes in the financial markets.
 - (b) is not necessary if the IASB proceeds with the proposal to adjust the margin with the entity's share of underlying items. They think that this proposal resolves the same concerns that the recognition of effects of changes in discount rates in OCI addresses.
82. However, others think that it is important that entities should also be permitted to present in OCI the effects of changes in discount rates. Some would also include in OCI the changes in estimates of cash outflows arising from changes in estimates of the returns on underlying items in OCI (discussed in paragraphs 55-57).
83. If the IASB decides that the effect of changes in discount rates for participating contracts should be presented in OCI, then feedback on the 2013 ED proposals indicates that an accounting policy choice should also be extended to contracts with participating features to address accounting mismatches. Some noted that the 'mirroring exception' dealt with accounting mismatches for only a narrow subset of participating contracts.
84. Some suggest alternative ways of determining the interest expense presented in profit or loss that could be used to avoid the accounting mismatches that arise because of the use of OCI. These suggestions are discussed in paragraphs 90-93.

Method for determining the interest expense

2013 ED proposal

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

changes in estimates of investment returns are generally caused by changes in market variables which is also reflected in the current discount rates.

86. The cash flows for non-participating contracts are *not generally affected* by movements in interest rates. In contrast, contracts with participating features contain cash flows that are affected by investment returns, and thus *are affected* by movements in market interest rates. Movements in market interest rates also affect the discount rate used to measure the insurance contract. Consider the following example:

Example 3 interest expense

Assume a participating contract credits 100% of the cash flows resulting from an underlying pool of assets to the policyholder. The crediting rate is not contractually based but rather as a result of entity discretion. At the inception of the five year contract premiums of CU100 are received, and the discount rate and asset yield are 5%. For simplicity, there is no risk adjustment or margin associated with this component of the insurance contracts liability. At the end of the first year, the assets mature and the proceeds of CU105 are reinvested at a 10% asset yield (based on a shift in the risk-free rate). There are no further changes in the discount rate. (Errors may occur due to rounding.)

The undiscounted estimated cash flows (ie nominal), the present value of these cash flows based on a rate locked in at contract recognition, and the liability (based on the current rate) initially and at the end of years 1 and 2 is as follows:

| | undiscounted | PV at locked-in rate | PV at current rate | PV differences |
|--------------------------------|--------------|----------------------|--------------------|----------------|
| | (A) | (B) | (C) | (B)-(C) |
| initial liability | 128 | 100 | 100 | - |
| liability at the end of year 1 | 154 * | 126 | 105 | 21 |
| liability at the end of year 2 | 154 | 133 | 116 | 17 |
| * 105×1.1^4 | | | | |

The statements of comprehensive income and financial position based on the tentative decisions are as follows:

| | | | |
|---|--|-----------------|-----------------|
| underwriting income | | (21) | - |
| investment income | | 5 | 11 |
| interest expense | | (5) | (6) |
| net investment income | | - | 4 |
| net income | | (21) | 4 |
| OCI ** | | 21 | (4) |
| comprehensive income | | - | - |
| | | | |
| | | <u>12/31/X1</u> | <u>12/31/X2</u> |
| investment | | 105 | 116 |
| insurance contracts liability | | (105) | (116) |
| accumulated deficit | | (21) | (17) |
| AOCI | | 21 | 17 |
| | | | |
| ** the OCI amounts in years' 1 and 2 represent the impact from the change in the discount rate (CU 21 in year 1) and the beginning of the subsequent reversal as the discount unwinds to interest expense ((CU 4) in year 2, calculated as the change in AOCI of CU 17 - CU 21) | | | |
| | | | |
| | | | |

87. Example 3 illustrates why presenting the interest expense in profit or loss at the discount rate that is locked-in at inception may be less useful when the cash flow amounts (vs. solely time value) are affected by changes in the performance of assets, including interest rates. Specifically, using the locked-in rate, the amounts that would be recognized as interest expense arising from the unwinding of the discount rate on the insurance contracts liability would be inconsistent with the variable rate nature of the financing. The amounts credited to the policyholder account balance are akin to the interest payments on the amounts “borrowed” by the entity. Because these payments vary with changes in interest rates (ie to the extent of their effect on the amounts credited to the policyholder, which are often highly correlated), portraying the interest expense as if it resulted from fixed-rate financing would seem to be inconsistent with the overall objective of presenting changes in the insurance liability in a way that provides useful information to users. It would also be inconsistent with 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.

88. 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 for only cash flows that vary directly with returns on underlying items. Paragraph 10 discusses that these contracts contain a mixture of types of cash flows that vary and do not vary directly with underlying items, and in different proportions which may change over time.
 - (b) Some think it would be more appropriate to use another discount rate to present the interest expense:
 - (i) the portfolio book yield ('book yield') (discussed in paragraphs 90-93); and
 - (ii) a discount rate calculated using an effective rate/level yield method (discussed in paragraphs 94-97).
89. The discount rate used for determining interest expense relates only to the presentation of interest expense in profit or loss and therefore, the amounts that would be recognised in OCI. The discount rate does not affect the measurement of the liability on the balance sheet.

Book yield

90. The book yield approach is consistent with how the underlying items are reported in profit or loss (ie market yield for assets held at FVPL and an amortised cost-based yield for assets held at amortised cost or FVOCI). When there are cash flows that extend beyond the current duration of the assets held, some would use an expected rate of return for those cash flows in the determination of the book yield.
91. The following is a description on how the proposed book yield would be calculated. The discount rate will need to be reset/re-determined when the underlying items are sold or matures and reinvested or if new underlying items are added.

| Asset accounted for IFRS | Book yield |
|---|--|
| Debt instruments at amortised cost or FVOCI | <p>Before the bond matures or is sold: the effective interest rate. Some would deduct “life time expected credit loss” (NB: which is different from the IFRS 9 impairment approach) and other adjustments made for the top-down or bottom-up approaches for determining the discount rate.</p> <p>After the bond matures: current market yield reflecting the rates at which the asset may be reinvested at.</p> |
| Equities at FVOCI | An illiquid risk-free rate; or an expected dividend income stream. |
| Investment properties at cost | Expected rent adjusted for expected defaults. |
| Debt instruments at fair value | The current market yield. Some would apply further adjustments consistent with those made under the top-down or bottom-up approaches for determining the discount rate (for example, expected defaults). |
| Equities and investment properties at FVPL | Expected future total return. Some would apply further adjustments consistent with those made under the top-down or bottom-up approaches for determining the discount rate. |

92. Those that support this approach think that it would report interest expense in profit or loss that is consistent with the interest income from the underlying items, and reduces or eliminates the accounting mismatch between the underlying items and the insurance contract in profit or loss. Consequently, they believe that this provides useful information.
93. Arguments against this approach are that:
- (a) some note that the underlying items may not be directly linked to the investment returns that are passed to the policyholder (for example, when there is discretion in the amounts and timings). In this instance, they question whether the proposal to present interest expense based on those investment returns would be a faithful representation of the interest expense.

- (b) the book yield differs from the discount rate that is applied to the cash flows of the insurance contract. Some think that recognising interest expense in profit or loss that is measured using a discount rate that has no relationship to the rate that is used to measure the insurance contract does not provide useful information because the amount of interest expense that is recognised on a cumulative basis might not equal the effect of discounting on the liability. This is because the amount of interest expense is a function of the accounting basis for the underlying items. Accordingly, some think that the amounts in OCI would be difficult to explain except by reference to the mechanics.
- (c) this approach would require the entity to identify the underlying items and therefore, the significant issues discussed in paragraphs 38-41 would need to be addressed.

Using a method similar to effective interest method

- 94. Another approach would be to use a discount rate that is determined using the effective interest method under IFRS 9. The entity would need to determine the discount rate using the method that exactly unwinds the amount in equity related to the effects of changes in the discount rate (some term this the accumulated OCI) over the life of the contract.
- 95. This approach was proposed in the FASB's Proposed Accounting Standards Update *Insurance Contracts* (Topic 834). (The FASB also proposed that an entity should recognise in OCI changes in the cash flows that arise from changes in estimates of investment returns.) Some that responded to the FASB's proposed Update supported the FASB's approach provided that it would be amended so that the discount rate would reflect the crediting pattern. Some that responded to the 2013 ED recommended that the IASB consider a similar approach.
- 96. Those that support this view note that this is consistent with the amortised cost and (FVOCI) requirements in IFRS 9. Consequently, they believe it provides information that is readably understandable because amortised cost is a well understood measurement basis. This approach would require the entity to identify

the underlying items and therefore, the issues discussed in paragraph 38-41 would need to be addressed.

97. However some note that this proposal would require entities to do an additional calculation to determine the interest expense at every reset date, and that this would introduce complexity.

Question 5—Presentation of interest expense

Do you have any comments or questions on the staff's analysis of the presentation of interest expense for contracts with participating features?

Insurance contracts revenue

98. The staff believe that there are no adaptations needed for the proposals on insurance contracts revenue for contracts with participating features if the 2013 ED proposals for contracts with participating features are unchanged. However, if the margin was adjusted for the entity's share of underlying items as proposed by some (discussed in paragraphs 31-44), further adaptations to the proposals for insurance contract proposals may be needed. One of the factors of the IASB's previous discussions is that the insurance revenue is the allocation of the premiums over the coverage period for the insurance coverage provided. If the changes in entity's share of the underlying items were adjusted in the margin as proposed by some, the insurance contract revenue would no longer represent an allocation of the premiums for the insurance coverage provided.

Question 6—Other questions

Do you have any comments or questions on any other aspect of the accounting for contracts with participating features?

World Standard-setters Meeting

Tuesday 30 September 2014
The Grange City Hotel (London)

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