STAFF PAPER

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IASB Meeting

Project	**Insurance contracts**		
Paper topic	Application of variable fee approach: Mutualisation		
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Objective

1. This paper discusses the consequences of the decisions on the level of aggregation for the measurement of an insurance contract when the application of the variable fee approach is required and when mutualisation (as defined in paragraphs 11–12) is present. The variable fee approach is described in Agenda Paper 2 *Cover note*

2. The paper:

   (a) provides background on the IASB's tentative decisions on the level of aggregation (paragraphs 3–7);

   (b) discusses what is mutualisation and when does it occur (paragraphs 8–18);

   (c) describes the implications of mutualisation on the determination of the contractual service margin under the variable fee approach and when gains and losses are recognised in profit or loss (paragraphs 19–22).

Background

3. The following section provides background to the IASB's decisions on the level of aggregation. A summary of the variable fee approach is provided in Agenda Paper 2 *Cover note*.

The level of aggregation for determination of the contractual service margin

4. At its June 2014 meeting, the IASB clarified that the objective of the proposed insurance contracts Standard is to provide principles for the measurement of an individual insurance contract. The level of aggregation does not affect the measurement of the fulfilment cash flows (ie the fulfilment cash flows would be the same if the unit of account was at the individual contract level, product type or the entire entity). However, the level of aggregation does affect the measurement of the contractual service margin and, therefore, affects when underwriting gains and losses are recognised in profit or loss. For example it affects:

    (a) whether losses are recognised at initial recognition;

    (b) when losses are recognised during the coverage period after initial recognition, and the amount of underwriting income that arises from the allocation of the margin; and

    (c) the amount of underwriting income on the derecognition of the contract.

5. By expressing the IASB's intent in the form of a principle, the IASB believed that entities would be able to use different techniques for measuring the contractual service margin, provided that the principle is met. In some cases, an entity's existing approach to aggregating contracts will meet the principle of measuring the contractual service margin at the individual contract level at inception. However, if that principle is not satisfied, the entity may still employ its existing approach to aggregating contracts, provided that the entity employs additional techniques or methods to ensure that the underwriting gains and losses recognised in profit or loss satisfies the principle.

6. In assessing whether the principle is met when aggregating contracts, for the purposes of determining the contractual service margin, the IASB's intention is that entities would satisfy the objective using only reasonable and supportable information available at inception. This reasonable and supportable information is information that is available without undue cost or effort.

7. In addition, to reduce costs for the preparer, the IASB has decided that it would require the level of aggregation to be determined only at inception. That is, the

entity would not revisit the decisions that were made at inception on the level of aggregation.

Mutualisation

8. The IASB's tentative decisions on the level of aggregation would apply to all insurance contracts, including contracts with participation features. However, in some insurance contracts with participation features, the terms of the contract are such that some policyholders have agreed that they will bear the risks of other policyholders that share in the same pool of the underlying items and, in particular, that they will share the risks of the expenses arising, including the cost of any guarantees written to other policyholders in the pool.

9. In those insurance contracts, policyholders have subordinated their claims to those of other policyholders, thereby reducing the direct exposure of the insurer to the collective risk of the group. This paper refers to this as mutualisation. Policyholders have mutualised their risk when the terms of their contract with the insurer require that:

    (a) they share with other policyholders in the returns of the same specified pool of underlying items; and

    (b) they may have their share of the returns of the underlying items reduced as a consequence of any required payments, including under any guarantees made to other policyholders that share in that pool; or

    (c) if their guarantees are in the money, their guarantees may reduce the share of underlying items returned to other policyholders.

10. Consequently, policyholders that enter into a mutualisation agreement will receive the higher of:

    (a) their share of the underlying items only after paying the expenses, including the guarantees that are in the money to any policyholders who shares in the same specified pool of underlying items.

    (b) their guaranteed amounts, if their guarantees are higher than the amounts determined using (a). For example, these could be minimum return guarantees and guaranteed payments on the occurrence of an insured event.

11. When the total returns of underlying items are insufficient to pay the expenses, even after reducing the payments due to other policyholders through mutualisation, the entity will be responsible for those expenses. Such expenses could include the costs of meeting guarantees made to policyholders. Effectively, the expenses, including the guarantees to a particular group of policyholders, are borne by other policyholders until the returns of the underlying items in which all policyholders are sharing are insufficient to meet the collective effect of all the expenses.

12. For example: Policyholder 1 and Policyholder 2 each have a similar amount invested in underlying items, but Policyholder 1 has a contract providing a minimum return guarantee of 4 per cent and Policyholder 2 has a contract providing a minimum return guarantee of 1 per cent. Both Policyholders 1 and 2 share in the same pool of underlying items. Those underlying items have an actual return of 3 per cent. For Policyholder 1, the actual return for the underlying items of 3 per cent is below their minimum return guarantee; therefore, the minimum return guarantee is triggered and Policyholder 1 receives 4 per cent. Policyholder 2 receives the residual return after deducting the minimum return guarantee paid to Policyholder 1, subject to their minimum return guarantee of 1 per cent. Thus, Policyholder 2 will receive a return that will be lower than the actual return of the underlying items of 3 per cent and higher than its minimum return guarantee of 1 per cent. If the returns of the underlying items are lower than the minimum return guarantees to both Policyholders 1 and 2 (for example, the returns are 1 per cent or the difference between Policyholder 2’s share of underlying items and their guaranteed amounts are insufficient to fund Policyholder 1’s guarantees), the entity will be responsible for the arising shortfall.

13. Mutualisation arises in a subset of contracts with participation features that qualify for the variable fee approach. Mutualisation occurs when the contractual agreement specifies (i) the returns from the underlying items that the policyholder participates in; and (ii) that the returns that are finally passed to the policyholder

may be reduced by any guarantees to other policyholders. One of the criteria for the variable fee approach is that the contract specifies that the policyholder participates in a clearly identified pool of underlying items. This is the same criteria as in (i). The criteria is needed because a clearly identifiable pool of underlying items is necessary to determine the value of the underlying items and is at the heart of the obligation between the policyholder and the entity.

What is not mutualisation?

14. Some argue that mutualisation occurs when:

(a) there is diversification of risk (paragraphs 15–16); and/or

(b) there is discretion in the amounts of the returns of the underlying items being passed to the policyholders (paragraphs 17–18).

The following paragraphs explain why the staff do not find these arguments persuasive.

Diversification of risk

15. The diversification of risk occurs when the entity reduces the risk by investing in assets that have different risks or by entering into insurance contracts that have different risk profiles. The diversification of risk may be achieved if an entity enters into contracts that behave differently to the risk that is being diversified. For example:

(a) an entity writes insurance contracts that offer a benefit paid on death (ie a life insurance contract). To diversify the risk, the entity writes other types of insurance contracts, for example, an annuity contract, which terminates on death. Doing so reduces the overall mortality risk to the entity than if it wrote solely life insurance contracts.

(b) an entity writes many insurance contracts that total CU1 million instead of a single insurance contract for the same insured event that also equals CU1 million.[1] Even though the total amount is the same under both

[1] In this paper, monetary amounts are denominated in ‘currency units’ (CU).

situations, CU1 million, the insurer has a lower risk in writing many contracts with different policyholders than in writing a single contract with a single policyholder.

The diversification of risk is reflected in the measurement of the insurance contract through the risk adjustment.

16. The diversification of risk usually occurs without the awareness of policyholders and has no effect on any claims that the policyholder may ultimately receive from the entity. In contrast, mutualisation occurs because the policyholders' contractual terms dictate that the returns of the underlying items paid to the policyholder occurs after considering all expenses, which includes any guarantees that are in the money to other policyholders. That is, in a mutualised contract, the policyholder is aware of the existence of other policyholders and it's claims or benefits are directly impacted by the claims and benefits of other policyholders.

Discretion

17. When the entity has discretion over the amount of returns it shares with policyholders, some would argue that these contracts behave in a economically similar way to those in which the policyholders have a contractual agreement to mutualise their risks. Consequently, there is **no** need for a contractual agreement.

18. However, the staff do not think that this is the case because, when the entity has discretion on the amount of returns shared with policyholders, there could be many factors that determine the amounts shared with policyholders. One such factor could be the guarantees required to be paid to other policyholders. However, in the absence of any contractual agreements, such factors may apply in some periods and not in others, or not at all. Consequently, the staff think that a contractual obligation between policyholders to mutualise their risks and returns is necessary to determine the effects of mutualisation in the determination of the variable fee approach.

Implication of mutualisation and the variable fee approach

19. If a policyholder enters into a contract that qualifies for the variable fee approach, and that contract specifies mutualisation with other policyholders, the transfers between the groups of policyholders could be reflected in the determination of the contractual service margin.[2]

20. Consequently, if the level of aggregation is determined taking into account the mutualisation:

    (a) there are no losses recognised in profit or loss when a group of policies become onerous (if, for example, the guarantee on those contracts is in the money), if another set of policyholders bears those losses; and

    (b) losses are only recognised in profit or loss from onerous contracts when the underlying items in the fund as a whole are insufficient to bear those losses, ie no other policyholder has the capacity to absorb those losses.

Additional requirements

21. Because no losses from a set of policyholders are recognised in profit or loss when there are sufficient returns from underlying items (see paragraph 20), some think that there should be additional requirements to increase the transparency of the risks arising from mutualisation arrangements as follows:

    (a) an entity may write contracts that are onerous at inception. However, if these losses are borne by the other policyholders under the mutualisation agreement, the losses would not be recognised in profit or loss at inception. Some think that an exception would be introduced so that those losses are recognised at inception. They do not think that that writing contracts that are onerous at inception is sound practice, because the entity is not acting in the best interest of the mutualised policyholders. In addition, this practice may incentivise competing entities to write also similar loss-making policies.

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[2] The staff note that there may be other ways of reflecting the mutualisation of risks between the policyholders (for example, in the fulfilment cash flows).

(b) additional disclosures so that information on the nature of the guarantees issued to policyholders is available. They are concerned that without specific disclosure requirements, outside investors may be unaware of the nature of the guarantees written or the extent to which some are already in the money.

22. The staff think that if the exception discussed in paragraph 21(a) is introduced, it would add further complexity to the model. The staff agree that further transparency would be useful for the issues raised in paragraph 21(b) and will consider whether further disclosures should be required to address those issues.

Question
Does the IASB have any views or comments on the staff's analysis of: (a) how the effect of mutualisation would be reflected in applying the variable fee approach; and (b) when there is mutualisation?