STAFF PAPER

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

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Purpose of the paper

1. This paper considers whether the IASB's previous tentative decisions relating to transition would need to be modified if the IASB were to require that entities apply the variable fee approach described in Agenda Paper 2 to measure insurance contracts with direct participation features.

Background

Transition for contracts without participation features

2. The IASB proposes that, for contracts without participation features, an entity should measure and present insurance contracts at the beginning of the earliest period presented retrospectively, if practicable.

3. This would require the entity to measure an insurance contract at the beginning of the earliest period presented as the sum of:

   (a) the fulfilment cash flows; and

   (b) the contractual service margin.

4. Measurement of the fulfilment cash flows is a current value measure and therefore does not require the use of historical data. However, determining the contractual

service margin at the beginning of the earliest period presented requires historical information as follows:

(a) the contractual service margin at the date of initial recognition, which is equal and opposite to the amount of the fulfilment cash flows at the date of initial recognition;

(b) the amount of the contractual service margin recognised in profit or loss between the date of initial recognition and the beginning of the earliest period presented; and

(c) the amount and timing of the changes in fulfilment cash flows that would have adjusted the contractual service margin (ie unlock the contractual service margin) between the date of initial recognition and the beginning of the earliest period presented.

5. Furthermore, an entity would need historical information for presentation proposes, specifically:

(a) the measurement of revenue as the release from the liability for remaining coverage adjusted for:

(i) losses that would have been recognised in profit or loss before the beginning of the earliest period presented; and

(ii) an allocation of the acquisition costs included in the measurement of insurance contracts.

(b) the interest expense recognised in profit or loss, if an entity has an accounting policy to present effect of changes in discount rate in other comprehensive income (OCI). The interest expense and the accumulated balance in OCI is determined using the discount rate at the date of initial recognition.

6. When retrospective application is not practicable, the IASB proposes a simplified retrospective approach that would enable entities to approximate retrospective application for the measurement of each component of the fulfilment cash flows at initial recognition of the insurance contract. The IASB decided to specify a simplified retrospective approach so that an entity could approximate retrospective application even when historical information cannot be obtained without using hindsight. Approximating retrospective application allows a degree

of comparability between contracts written before and after the beginning of the earliest period presented, which would not be achieved if an entity were to use another approach to determine the contractual service margin.

7. When an entity applies the simplified retrospective approach, it would:

   (a) estimate the cash flows at initial recognition of insurance contract as equal to the expected future cash flows at the beginning of the earliest period presented adjusted by the cash flows that occurred between the date of initial recognition and the beginning of the earliest period presented. This approach treats all changes in estimates before the beginning of the earliest period presented as if they were known at initial recognition of insurance contracts.

   (b) determine the yield curve at the date of initial recognition using an observable yield curve that, for the three years before the beginning of the earliest period presented, best approximates the yield curve for insurance contracts in-force at that date. If there is no such observable yield curve, an entity should adjust an observable yield curve using an average spread between that observable yield curve and the yield curve for insurance contracts in-force at that date. The spread should be determined as an average over at least three years before the beginning of the earliest period presented.

   (c) estimate the risk adjustment at the date of initial recognition by adjusting the risk adjustment at the beginning of the earliest period presented by the assumed release of the risk before the beginning of the earliest period presented. The assumed release of risk should be determined by reference to release of risk for similar insurance contracts that the entity issues at the beginning of the earliest period presented.

8. Nonetheless, the IASB noted that the simplified retrospective approach in paragraph 6 might still be impracticable. This would be the case if the entity could not obtain information about the cash flows that occurred between the initial recognition of the contract and the beginning of the earliest period presented. This would mean that the entity would not have the information needed to determine

the contractual service margin using the simplified approach. Accordingly, the IASB tentatively decided that when both retrospective application and the simplified retrospective approach are impracticable, an entity should use a "fair value approach" for determining the contractual service margin at initial recognition of insurance contract. In the fair value approach for determining the contractual service margin an entity would:

(a) determine the contractual service margin (or carrying amount of loss) at the beginning of the earliest period presented as the difference between the fair value of the insurance contract and the fulfilment cash flows measured at the beginning of the earliest period presented; and

(b) determine interest expense in profit or loss, and the related amount of other comprehensive income accumulated in equity, by estimating the discount rate at the date of initial recognition using the simplified retrospective approach explained in paragraph 7(b).

Staff analysis: applying the variable fee approach on transition

Contractual service margin at the beginning of the earliest period presented

9. In Agenda Paper 2B for the March 2015 Board Meeting the staff considered a 'variable fee approach' for direct participation contracts. This approach treats the contract as creating an obligation for the entity to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service. The variable fee approach is summarised in Agenda Paper 2.

10. As with the general model, the contractual service margin in the variable fee approach would be adjusted for changes in estimates relating to future service and allocated to profit or loss in line with the delivery of service. The key difference between the variable fee approach and the general model is that when applying the variable fee approach, the contractual service margin would be adjusted after initial recognition by changes in estimates of the variable fee for service.

11. The variable fee for service at initial recognition can be determined as an amount equal to the fair value of an entity's expected share of the returns of underlying

items less the expected present value of the net cost of providing the contract, including the costs of guarantees. Changes in the variable fee for service would comprise changes in the fair value of the entity's expected share of returns as well as changes in the risk-adjusted expected present value of the costs of providing the contract. Therefore, the contractual service margin at the end of each reporting period could be characterised as:

(a) the variable fee for service, comprising:

(i) the fair value of the entity's share of the returns from the underlying items at the end of the reporting period;

(ii) plus/minus the risk-adjusted expected present value of the net cost of providing the contract at the end of the reporting period;

(b) minus/(plus) the cumulative amounts of the contractual service margin/(loss) recognised in the profit or loss between the initial recognition of the contract and the end of the reporting period.

12. For retrospective application, the entity would need to determine the contractual service margin at the beginning of the earliest period presented as if the new requirements had always been applied. This means that the entity would need to determine the information in paragraph 11 to determine the contractual service margin at the beginning of the earliest period presented.

13. The staff notes that the entity does not require historical information to determine the amounts in paragraph 11(a). However, the entity would need historical information to determine the cumulative amounts of the contractual service margin/(loss) recognised in profit or loss (ie the amount in paragraph 11(b)). Determining that amount would require that the entity estimate:

(a) the amount of the contractual service margin at initial recognition; and

(b) the timing and amount of the subsequent changes in estimates that would have adjusted the contractual service margin before the beginning of the earliest period presented, including the effect of changes in fair value of the underlying items on the fulfilment cash flows at each reporting period. This information would be needed to determine how much contractual service margin would have been released in each period between initial recognition and the beginning of the earliest period presented.

14. The staff believes that, unless the entity had previously recorded the fair value of underlying items at the end of each reporting period, retrospective application would often be impracticable for entities applying the variable fee approach because estimating that information would require the use of hindsight.

15. Furthermore, the staff notes that the simplified retrospective approach that the IASB developed for contracts without participation features could not be readily applied to contracts that are accounted for using the variable fee approach. This is because the simplified retrospective approach estimates the contractual service margin at the beginning of the earliest period presented as if all changes in estimates before that date were known at initial recognition. For contracts without participation features, those changes in estimates relate only to the cash flows of the contract. However, for the variable fee approach, those changes include changes in the entity's share of the fair value of underlying items. Unless the entity had previously recorded this information, it would not be possible to estimate the entity's share of the fair value of the underlying items (that would have unlocked the contractual service margin) at initial recognition without the use of hindsight.

16. The staff proposes that the IASB consider the following approaches to address this difference:

    (a) *Option 1: do not provide additional simplification for the variable fee approach*. The staff notes that this would mean that an entity applying the variable fee approach would generally apply the fair value approach for determining the contractual service margin at the beginning of the earliest period presented. However, the objective of the fair value approach is not to estimate a value of contractual service margin that approximates the value of the contractual service margin had the standard always been applied. Therefore, applying a fair value approach would mean that there would be reduced comparability between contracts written before and after the beginning of the earliest period presented.

(b) *Option 2: provide an additional simplification for the variable fee approach to the retrospective simplified approach*, as discussed below.

17. As described in paragraph 13, determining the cumulative release of the contractual service margin before the beginning of the earliest period presented would require that the entity estimate:

(a) the amount of the contractual service margin at initial recognition; and

(b) how much contractual service margin would have been released in each period between initial recognition and the beginning of the earliest period presented.

18. To calculate the amount of the contractual service margin at initial recognition, an entity could add:

(a) the expected variable fee at the beginning of the earliest period presented, adjusted to reflect time value of money between the date of initial recognition and the beginning of the earliest period presented. The expected variable fee at the beginning of the earliest period presented comprises of:

(i) the fair value of the entity's share of the returns from the underlying items at the beginning of the earliest period presented;

(ii) plus/minus the risk-adjusted expected present value of the net cost of providing the contract at the beginning of the earliest period presented; and

(b) the payments of cash flows related to the variable fee that occurred before the beginning of the earliest period presented. Such payments would include, for example, amounts distributed from the underlying items to the policyholders and the entity, and payments of any cash flows relating to expenses included in the fulfilment cash flows.

19. To estimate how much contractual service margin would have been released in each period between initial recognition and the beginning of the earliest period presented, the entity could assume that the contractual service margin at initial recognition was released according to the pattern of services. At the March 2015 meeting, the staff proposed that this would be done on a straight-line basis.

20. The staff believe that results achieved using this method would differ from those calculated using the retrospective approach because an entity would assume that all changes in the variable fee for service (resulting from the changes in fair value of the underlying items and fulfilment cash flows) were known at initial recognition of the contract. Consequently, this approach is similar to the cash flows simplification for contracts without direct participation features (see paragraph7(a)). The staff believe that this method would provide a reasonable approximation of the retrospective approach in a similar way to other simplifications already provided for contracts without participation features explained in paragraph 6. This is because according to this method an entity will use information available at the beginning of the earliest period presented to determine the contractual service margin at initial recognition.

Current period book yield

21. In Agenda Paper 2B for the March 2015 Board Meeting, the IASB considered current period book yield approach for determining amounts recognised in profit or loss and in OCI. In the current period book yield approach, the entity separates the change in the time value of money on the insurance contract and recognises:
    (a) in profit or loss an amount of investment expense/income from insurance contracts determined in a way that there is no investment margin between the insurance contracts and the underlying items.
    (b) in OCI the difference between the total change in time value of money on the insurance contract and the amount recognised in profit or loss.

22. Those amounts would not require using historical information because they are calculated using the information from the current period.

23. However, historical information might be needed to estimate the accumulated balance of OCI recognised at the beginning of the earliest period presented when the current period book yield approach is applied. This is because the amount in accumulated in OCI is the difference between:
    (a) the value of the insurance contract at the beginning of the earliest period presented and

(b) the cumulative amount of interest income/expense recognised in profit or loss between the initial recognition of the insurance contract and the beginning of the earliest period presented. This amount equals the cumulative amount of the interest income/expense recognised in profit or loss for underlying items for the same period. Such an amount would be difficult to estimate retrospectively because an entity would need to estimate the value of underlying items and any accumulated balance of OCI recognised for those underlying items at the date of initial recognition of the insurance contracts. The staff believe that this would be often impracticable without using hindsight.

24. Consequently, the staff propose that the IASB provide a simplification to enable entities to approximate the cumulative OCI for insurance contracts, as follows:

(a) The entity should assume that there are no differences in the accumulated balance of OCI for the insurance contracts and the underlying items because of differences in timing between initial recognition of the insurance contracts and initial recognition of underlying items.

(b) The entity should assume that the accumulated balance of OCI for the insurance contract is determined as follows:

(i) When underlying items are measured at FVPL, there would be no amounts accumulated in OCI for both underlying items and insurance contracts.

(ii) When underlying items are measured at FVOCI, the accumulated balance of OCI for the insurance contracts would be equal and opposite to the accumulated balance of OCI recognised for the underlying items.

(iii) When underlying items are measured at amortised cost, the accumulated balance of OCI for the insurance contracts would be the difference between the amortised cost of the underlying items and their fair value.

Question to Board Members

Do you have any questions or comments on the staff's proposal that, for contracts with the direct participation features, the simplified retrospective approach should be modified for:

(a) determining the cumulative release of the contractual service margin before the beginning of the earliest period presented (see paragraphs 17-19) ; and

(b) determining the amount accumulated in OCI when the current book yield approach is applied (see paragraph 24)?