STAFF PAPER

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IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Specifying the effect of discretion in the general model		
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Purpose of this paper

1. At the November 2015 Board meeting, the Board asked the staff to consider further whether and how to specify how to determine the effect of discretion in participating contracts.[1] This issue arises only under the general model (the Appendix explains why this is the case). This paper responds to the Board's request.

Question for the Board

2. This paper asks the Board which of the following alternatives does it wish to require:
   (a) an entity to specify the effect of discretion (the approach set out in paragraphs 14-16); or
   (b) an entity to determine the effect of discretion by reference to the market (the approach set out in paragraphs 7-8).

[1] The Agenda Paper is available at: http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/November/AP02A-Insurance-Contracts.pdf.

Background

3. Participating contracts will often include cash flows that the entity expects to pay, but which it has the discretion to change. Such cash flows are included in the fulfilment cash flows. Changes in estimates of discretionary cash flows (hereafter, referred to 'as the effect of discretion') would adjust the contractual service margin because they are regarded as relating to future service.

4. The 2013 Exposure Draft *Insurance Contacts* (the 2013 ED) simply stated the principle that changes in future service adjust the contractual service margin and did not provide guidance on how to determine the effect of discretion.

5. If the Standard does not specify how discretionary cash flows are determined, there could be a difference in the cash flows considered in the calculation of the effect of changes in market variables and discretion. Those different approaches result in different amounts recognised as underwriting activity and as investment activity. As discussed in Agenda paper 2A for the November 2015 Board meeting, this is because the proposals in the 2013 ED require an entity to:

   (a) measure the expected cash flows assuming there is no change in the discretion exercised by the entity at the current interest rate (recognised all in profit or loss or disaggregated between profit or loss or other comprehensive income (OCI) depending on the entity's accounting policy choice); then

   (b) measure the effect of any change in the discretionary cash flows using the rate at inception (recognised in the CSM),[2] with the remaining change in discretionary cash flows measured at the current rate being recognised in profit or loss.

6. That in turn will affect the timing of insurance investment expense and underwriting income, because the accretion and allocation of the CSM will be based on different amounts.

[2] All changes in cash flows estimates that adjust the CSM are measured using the rate at inception of the contract.

Specify how the principle is achieved

7. Agenda paper 2A for the November 2015 noted the staff view that there could be confusion over how discretionary cash flows should be determined in the general model. In addition, different views by entities about their discretion could result in significant lack of comparability for similar contracts across entities. The staff is also aware that if the Standard did not specify how to determine discretionary cash flows, there could be the potential for entities to manage the process to achieve particular results.

8. Paragraphs 9-13 summarises the four alternatives discussed in the November 2015 Agenda Paper and why the staff recommended using the market as a benchmark to determine the effect of discretion.

How to specify the discretionary cash flows

9. At its November 2015 meeting, the Board considered four ways to distinguish changes caused by market variables (that are recognised in the statement of comprehensive income) and changes in discretionary cash flows (that adjust the CSM). That paper identified four ways to identify what should be regarded as the effect of discretion and staff rejected three of those four ways.

10. The Board considered those ways in the context of the following simplified example. An entity issues an insurance contract for a premium of CU1000 paid at inception and a maturity of 20 years. There is a guaranteed return to policyholders of 2%, with additional return at the entity's discretion. At inception of the contract the entity expects to generate 5% return on assets held and to retain a spread of 0.5%, ie to return 4.5% to the policyholders. The entity invests in assets that return a fixed rate of 5% for two years. One day after inception, interest rates fall to 1%. The entity then expects to give the policyholders 4.5% for two years, and then the guaranteed return of 2% thereafter.

11. The four ways of determining what was discretionary (and what was not discretionary) considered by the Board were:

    (a) View (a): Regarding as not discretionary the return expected to be paid to the policyholder as at inception, and treating any change from the amount expected at inception as discretionary. In the context of the example, the entity would have expected to pay a 4.5% return at inception but uses its discretion to reduce that return after the second year, subject to the guarantee.

(b) View (b): Regarding as not discretionary the investment income from the assets that the entity holds less a spread, or the guaranteed return if higher. In the context of the example, the entity would have expected to pay the interest income of 5% on the assets it holds, less a 0.5% spread, or the guaranteed return if higher. Under this view, it has not used its discretion to change the promise. Changes in the 0.5% spread would be regarded as discretionary.

(c) View (c): Regarding as not discretionary the expected return based on current market conditions less a spread, or the guaranteed return if higher. In the context of the example, the entity uses its discretion to increase the return to policyholders to 4.5% for the first two years. Also, changes in the 0.5% spread would be regarded as discretionary.

(d) View (d): Regarding as not discretionary the return fixed at the guaranteed rate. Everything else is the effect of discretion. In the context of the example, all payments above 2% would be regarded as the effect of discretion.

12. The staff has rejected the following views:

(a) Views (a) and (d). The views in 11(a) and 11(d) regard any change in the undiscounted expected cash flows as being the result of a change in discretion. The staff do not think that treating all such changes as being related to future service rather than current or past service results in a faithful representation of the contract. Rather, some of the changes should be regarded as offsetting the effects of market variables on the non-discretionary elements. There was little interest from Board members in exploring the views in 11(a) and 11(d), and the staff does not explore them further.

(b) View (b). The difference between views (b) and (c) is in what is regarded as the base for determining the amount paid to the policyholder. In view (b), the amount is regarded as based on assets that the entity holds, while in view (c) the amount is regarded as based on current market conditions.[3] To apply view (b), an entity would always have to indicate what assets that it holds determine the amounts due to policyholders. But for some contracts, the entity may not regard any assets that it holds as determining the amounts due to policyholders. Hence view (b) is not an approach that can always be applied.

13. Accordingly, staff thinks that only view (c) is viable if the Board wishes to specify how an entity should determine the effect of discretion.

New view

14. At the November 2015 meeting, some Board members suggested an approach that combined view (b) and view (c) to reflect how the entity viewed its discretion under the contract. The staff think that such an approach would require an entity to specify at the inception of the contract how it viewed its discretion under the contract, and to use that specification to distinguish between the effect of changes in market variables and changes in discretion. That specification need not be limited to current market returns or interest income on assets held, but could include whatever factors the entity uses to determine the amounts due to policyholders, such as reference assets not held by the entity or indices. If the entity is unable to specify in advance how it will determine the amounts due to policyholders, then the default benchmark would be a current market return.

15. However, the staff do not think that this is significantly different from simply stating the principle in the 2013 ED discussed in paragraph 4. This is because the staff think that the 2013 ED principle would require an entity to specify how it viewed its discretion under the contract, and to use that specification to distinguish between the effect of changes in market variables and changes in discretion. Such a determination would need to be consistent with assumptions the entity used in estimating the fulfilment cash flows.

[3] If the entity holds assets with returns that reflect market conditions (eg variable rate assets), the two views (b) and (c) give the same results. However if the entity holds, for example, fixed rate bonds, the two approaches give different results.

16. Entities that gave different specifications about discretion would get different results for similar contracts. However, the staff think that the different results could provide useful information to the users of financial statements because such information reflects the entity's perspective about its discretion.

Conclusion

17. The staff think that there are two viable alternatives:

    (a) Allowing the entity to specify how it determines the effect of discretion. This is effectively relying on the principle in the 2013 (the approach set out in paragraphs 14-16).

    (b) Specifying further guidance by stating that an entity must determine the effect of discretion by reference to the market (the approach set out in paragraphs 7-8).

18. At the November 2015 Board meeting the staff recommended specifying further guidance (alternative in paragraph 17(b)) over simply relying on the principle in the 2013 ED (alternative in paragraph 17(a)). However, on further reflection we think the balance between these alternatives is finely balanced.

Question: Treatment of discretionary changes under the general model
Does the Board wish to proceed by requiring: (a) an entity to specify the effect of discretion (the approach set out in paragraphs 14-16); or (b) an entity to determine the effect of discretion by reference to the market (the approach set out in paragraphs 8-9)?

Appendix: Why this is not an issue for contracts accounted for under the variable fee approach?

A1. We note that distinguishing discretionary cash flows from other types of cash flows is an issue only for the general model. It is not necessary to distinguish discretionary cash flows for the variable fee approach because, in the variable fee approach, an entity would be required to:

(a) Measure the effect of any change in the estimate of the obligation to pay to the policyholder an amount equal to 100% of the fair value of the underlying items (recognised all in profit or loss or disaggregated between profit or loss or OCI, depending on the entity's accounting policy choice).

(b) Measure the effect of any change in the estimate of the variable fee for future services (recognised in the CSM).

So, under the variable fee approach, the distinction between discretionary changes and changes in market variables is not relevant. What determines where changes in the fulfilment cash flows are recognised is whether or not the change is a change in the underlying items or the change relating to the variable fee for service.

A2. The variable fee approach would apply when:

(a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;

(b) the entity expects to pay to the policyholder an amount equal to a substantial share of the returns from the underlying items; and

(c) a substantial proportion of the cash flows that the entity expects to pay to the policyholder should be expected to vary with the cash flows from the underlying items.

A3. Accordingly, the question of how to identify the changes in discretionary cash flows that would be recognised in the contractual service margin arises only when payments to the policyholder do not meet any of the criterion above.