

Insurance Accounting Alert

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IASB discusses alternative proposal for participating contracts

What you need to know

- ▶ The Board held an educational discussion on an alternative proposal for participating contracts based on a paper submitted by the European CFO Forum.

Overview

During its November 2014 meeting, the International Accounting Standards Board (IASB, or Board) continued redeliberations on its 2013 Exposure Draft *Insurance Contracts* (ED). The Board has essentially completed the development of the model for non-participating contracts during previous meetings, including the measurement on transition to the new insurance contracts standard.

During its November meeting, the Board held a discussion on an alternative proposal developed by the European CFO Forum (the CFO Forum) for insurance contracts with participating features (participating contracts). This proposal is based on six key areas of principle, notably:

- ▶ Full unlocking of the Contractual Service Margin (CSM)
- ▶ Profit recognition pattern
- ▶ Presentation of interest expense in profit or loss
- ▶ Scope
- ▶ Single measurement basis
- ▶ Non-mandatory use of other comprehensive income (OCI)

The CFO Forum submitted a detailed description of this alternative proposal to the Board; this description has been included in the [IASB staff insurance paper](#) for the November meeting.

The purpose of this meeting was to give the CFO Forum the opportunity to present their proposal to the Board, and for Board members to gain a better understanding of the alternative proposal by asking questions. The meeting was educational, no decisions were taken. The main themes of the discussions are summarised below for each of the key principles.



Building a better
working world

Full unlocking of the CSM

The alternative proposal for participating contracts includes a full unlocking mechanism to adjust the CSM for changes in all sources of profit, both non-financial and financial, from insurance contracts. The intention is to measure the CSM as a current estimate of the expected remaining future profit from the participating contract. A key aspect of this approach is to unlock the CSM for the shareholders' share in the changes of underlying items in the period, also referred to in the alternative proposal as 'full unlocking'.

The Board asked the CFO Forum whether the unlocking of a CSM amount determined at inception would give the same outcome as a prospective re-measurement of the CSM based on a point-in-time estimate of expected remaining profits from the contract. The CFO Forum representatives responded that the crux of the alternative proposal is to have consistency between the determination of the CSM at inception and at subsequent reporting dates, such that the CSM would reflect the circumstances at the reporting date.

A recurring theme during the discussions was the unit of account, in particular, with regard to the level of aggregation for unlocking the CSM. The CFO Forum representatives commented that the alternative proposal would apply an 'open' portfolio approach (i.e., a portfolio where contracts issued in the period are evaluated together with contracts written in previous periods). This caused concern among some Board members because, in their view, it could result in the commingling of profitable contracts and contracts with economic losses over time.

Profit recognition pattern

Under the alternative proposal, the profit from insurance contracts should be recognised in profit or loss over the coverage period in a systematic way that best reflects the transfer of services provided under a contract. Accordingly, the driver of the CSM release will be determined based on the predominant service provided under the contract.

Some Board members commented that, in their view, the alternative proposal only provided a high-level principle for the CSM release and they queried whether it would be sufficient to only have a high-level principle without including further guidance on how to apply the principle. The CFO Forum representatives responded that the wording in their paper was not intended to represent only a high-level principle, adding that no detailed additional guidance would be necessary because the number of possible service drivers would be limited to asset management and insurance coverage.

One Board member felt the proposed disclosure of reconciliation of changes in the CSM would be very useful to users of financial statements and queried whether it would be possible to tailor such disclosures. The CFO Forum representatives replied that, according to the CFO Forum proposals, this information could be provided in different ways and at various levels of granularity.

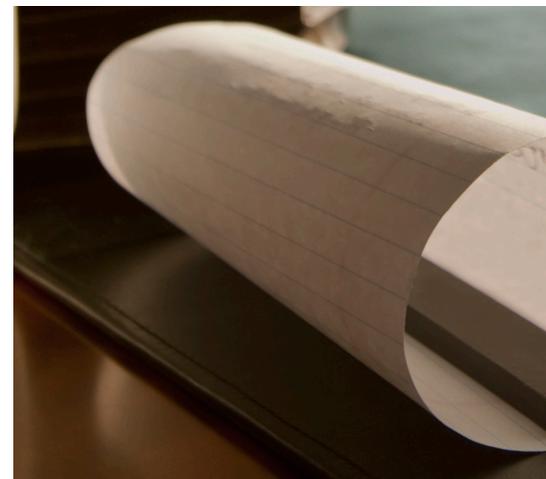
Presentation of interest expense in profit or loss

Under the alternative proposal, the interest expense in profit or loss on the insurance liabilities should be determined in a way that is consistent with how the returns on the underlying items are reported in profit or loss. This would be achieved through the notion of a book yield method. Under the book yield method, the rate for calculating the interest expense would be based directly on the accounting returns in profit or loss from the underlying items. These accounting returns would be used to construct a yield curve for the entire duration of the estimated cash flows of participating contracts, taking into account reinvestment assumptions based on current market yields.

Some Board members acknowledge that the concept of a book yield would contribute to resolving accounting mismatches in profit or loss caused by the mixed measurement model for financial instruments. However, one Board member observed that the book yield method would not resolve all accounting mismatches, for example, for

equity securities that are reported at fair value through other comprehensive income (FVOCI) and property held at cost. That Board member also queried how a book yield method would work if a risk-neutral approach is applied to measurement of the liabilities (i.e., risk-free discount rate adjusted for the liquidity characteristics of the insurance liability cash flows). The CFO Forum representatives responded that the discount rate can be determined in different ways, but that, in their view, it was difficult to imagine how a fully risk-neutral valuation could be applied as any asset dependency of the insurance liabilities needs to be reflected in the measurement of these liabilities.

Another observation from Board members was that the size of the CSM of a contract would differ depending on whether the book yield for that contract is based on a 'through OCI' or 'through profit or loss' approach. In the view of these Board members, this would result in different profit or loss results for contracts that are the same just because the assets are measured differently. The CFO Forum responded that the overall performance should be evaluated by looking at the performance in profit or loss and OCI together.



Scope

The alternative approach would apply to all types of participating contracts to ensure a consistent treatment for all contracts with similar economic characteristics, irrespective of whether an insurance entity is required to hold the underlying items or it has discretion over the amount and timing of profit sharing with the policyholder.

One Board member asked whether the alternative proposal would only be applicable in situations where an insurance entity actually holds the underlying items, or whether the proposal could also apply to cases where an insurance entity would not hold the underlying item (e.g., for certain index-linked products).

CFO Forum representatives commented that, in practice, insurance entities would typically hold the assets. Therefore, the alternative proposal does not intend to target participating contracts in which the underlying assets are not held by the insurance entity. CFO Forum representatives also re-iterated that, to the extent the assets held by the insurance entity do not match the entire duration of the liability, reinvestment assumptions based on current rates would be used for determining both the liability discount rate and the book yield over the unmatched period.

Single measurement basis

The CFO Forum proposal envisages a single-measurement basis that is based on the building block approach applied to both non-participating and participating contracts, reflecting asset dependency where this would be part of the characteristics of the liability. Options and guarantees embedded in the contract would be fully included in the building block measurement like any other insurance contract cash flow. Changes in the value of options and guarantees would be presented consistently with changes in other elements of the contract. Consequently, bifurcation of cash flows would not be necessary under the alternative proposal.

Board members raised several concerns around the treatment of options and guarantees. One Board member commented that an environment of prolonged low-interest rates, below a guaranteed rate, would seem to turn a participating contract into a non-participating contract as there would no longer be asset-dependency. The Board member questioned whether there was a justification in such situation for different accounting treatments (i.e., participating and non-participating) for contracts that behave the same economically. CFO Forum representatives believed that, practically, it would only be necessary to perform the classification of whether a contract is a participating contract at inception.

Board members also asked for clarification on how the effect of changes in the measurement of options and guarantees would be recognised under the alternative proposal. CFO Forum representatives explained that the treatment would follow the overall model: measurement changes would be adjusted against any remaining CSM, but with the possibility to use OCI for changes in the time value of options and guarantees if an insurance entity elects to recognise the effect of changes in discount rates in OCI. Some Board members noted that this treatment was not clear from the description of the alternative model in the CFO Forum's paper.

One Board member commented that such treatment would result in an accounting mismatch if derivatives are used to hedge options and guarantees as derivatives are accounted for at fair value through profit or loss under IFRS 9 *Financial Instruments*. CFO Forum representatives responded that derivatives that are linked to the insurance liability for the purpose of economic hedging should be incorporated in the unlocking of CSM. The Board member indicated that such an approach would be a form of hedge accounting without restrictions. CFO Forum representatives agreed that further guidance needs to be developed to determine when a derivative could be linked to the insurance liability.



Non-mandatory use of OCI

The alternative model envisages the election of a 'through OCI' and 'through profit or loss' presentations for insurance liabilities to allow insurance entities to mitigate accounting mismatches as much as possible within the context of an entity's asset liability management strategies for participating contracts.

One Board member asked whether the CFO Forum considered a full unlocking approach to the CSM combined with a 'through profit or loss' approach. In the view of this Board member, this would avoid different CSM figures for similar contracts and would also be consistent with the notion of a fully remeasured CSM. CFO Forum representatives noted a 'through OCI' presentation is available for non-participating contracts and they believe this presentation also should be available for participating contracts to maintain consistency.

At the end of the meeting, the representatives of the CFO Forum re-emphasised that the ultimate accounting model for participating contracts, in order to be understandable, should provide consistent reporting without any artificial volatility and undue complexity. In response, the IASB Chair stressed that the model should also be sufficiently robust and comparable.

The staff will continue to work on a model for participating contracts; the Board will make a decision on a comprehensive model at a future meeting.

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How we see it

The Board continues to demonstrate that it has an open mind to finding a satisfactory solution for participating contracts.

However, the number and variety of questions asked by the Board clearly signalled that more work is needed on key areas of the alternative proposal before it can be leveraged as the basis for the accounting model for participating contracts in the future standard. The Board did not ask many questions on the concept of unlocking the CSM for the changes in the shareholder share. Whilst it might be too early to draw conclusions based on the lack of questions, this might suggest that the Board is willing to consider CSM unlocking of the shareholder share as part of a solution for participating contracts.

Resolving the overarching theme of the unit of account will be a key aspect of finding a solution for participating contracts.

What's next?

The Board's next meeting on the insurance contracts project is expected to be early 2015. The topics have not yet been announced, but will likely cover further re-deliberations on participating contracts. The IASB expects to publish a final standard in 2015.