STAFF PAPER

June 2015

REG IASB Meeting

Project	Insurance Contracts		
Paper topic	Cover note		
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Introduction

1. This cover note:

   (a) introduces the papers for this meeting (paragraphs 2-4);

   (b) provides an overview of project progress (paragraphs 7-11); and

   (c) describes next steps (paragraph 12).

Papers for this meeting

2. The papers for this meeting consider the measurement of direct participation contracts, as follows:

   (a) Agenda Paper 2A *Application of the general model to contracts with participation features* provides a reminder of the IASB's tentative decisions to date on the measurement of insurance contracts. There are no decisions sought in this paper.

   (b) Agenda Paper 2B *Variable fee approach for direct participation contracts* discusses whether the IASB should modify the general measurement model described in Agenda Paper 2A in some circumstances. In this paper, the staff recommend:

      (i) that, for contracts with direct participation features, the IASB should modify its general measurement model for accounting for insurance contracts so that changes in the estimate of the fee the entity expects to earn from the contract are adjusted in the contractual service margin. That fee is an amount equal to the entity's expected share of the returns on underlying items less any expected cash flows that do not vary directly with the underlying items.

(ii) that contracts with direct participation features should be defined as contracts for which:

1. the contractual terms specify that the policyholder participates in a defined share of a clearly identified pool of underlying items;
2. the entity expects to pay to the policyholder an amount equal to a substantial share of the returns from the underlying items; and
3. 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.

(c) Agenda Paper 2C *Recognition of contractual service margin in profit or loss for contracts with participation features* considers the recognition of the contractual service margin in profit or loss for contracts with participation features. In this paper, the staff recommend that for insurance contracts with participation features, an entity should recognise the contractual service margin in profit or loss on the basis of the passage of time.

3. One of the consequences of the variable fee approach described in Agenda Paper 2B is that when an entity hedges interest rate risk in insurance contracts using derivatives, changes in interest rates would be recognised in profit or loss for the derivative and as an adjustment to the contractual service margin for the insurance contract. Agenda Paper 2D *Hedging of risks related to insurance activities* discusses this issue. There are no decisions sought in Agenda Paper 2D.

4. In addition, the papers for this meeting discuss the interaction of the effective date of IFRS 9 and the forthcoming insurance contracts Standard, as follows:

(a) Agenda Paper 2E *Application of IFRS 9* Financial Instruments *before the new insurance contracts Standard* discusses feedback on applying

IFRS 9 prior to the new insurance contracts Standard and provides staff observations about the issues raised*;*

(b) Agenda Paper 2F *Use of IFRS 4* Insurance Contracts *to address the consequences of applying IFRS 9* Financial Instruments *before the new insurance contracts Standard* considers how entities would apply IFRS 9 in conjunction with existing IFRS 4; and

(c) Agenda Paper 2G *The complexity of deferring the effective date of IFRS 9* Financial Instruments *for the insurance industry* discusses the complexities that would arise if the IASB were to defer the effective date of IFRS 9 Financial Instruments for the insurance industry until the effective date of the new insurance contracts Standard.

5. Agenda Papers 2E-2G have been provided for information only and no decisions are sought.

6. The staff expect to discuss Agenda Papers 2D-2G at the education session on Tuesday 23 June 2015, and Agenda Papers 2A-2C at the board meeting on Thursday 25 June 2015.

Overview of project progress

7. Since January 2014, the IASB has been deliberating issues raised in its third consultation document, a revised Exposure Draft issued in June 2013. The 2013 ED *Insurance Contracts* builds on the proposals previously set out in:

(a) the Discussion Paper *Preliminary Views on Insurance Contracts,* published in May 2007, which explained the IASB's initial views on insurance contracts; and

(b) the Exposure Draft *Insurance Contracts*,, published in July 2010, which developed those initial views into a draft Standard.

8. In its deliberations, the IASB has sought to balance many diverse views and develop an approach that provides useful financial information and that can be applied in all jurisdictions that apply IFRS.

9. So far, the IASB has completed its discussions on the model for insurance contracts without participation features. Appendix A provides an overview of the tentative decisions made to date.

10. However, a significant challenge for the IASB has been the accounting approach for contracts with participation features. A participation feature causes the cash flows to the policyholder to vary with the returns on assets. The IASB is considering the accounting for contracts with participation features in the context of adaptations that might be needed to the general model for contracts without participation features.

11. Since May 2014, the IASB has held numerous education sessions during which the IASB directed the staff in developing proposals for the application of the general model to contracts with participation features. At this meeting, the staff ask the IASB for decisions relating to modifications to the general measurement model for some contracts with participation features (AP 2B and AP 2C). Much of the analysis in these papers has been previously discussed by the IASB in more detail in these education sessions. Therefore, for Board members' convenience, Appendix B lists the staff papers on insurance contracts with participation features that were presented at those education sessions.

Next steps

12. During the remainder of 2015, the staff expect the IASB to consider the remaining technical decisions. In particular, if the IASB decides to modify the general model as proposed in Agenda Paper 2B, then the staff plans to consider at a future meeting the differences between the IASB's general model and the modified model described in Agenda Paper 2B (referred to as the variable fee approach), and whether those differences should be eliminated.

13. The staff expect that the new Standard will not be published before the end of 2015. The staff do not expect to consider the mandatory effective date of the new insurance contracts Standard until after the IASB has otherwise concluded its deliberations.

Appendix A: Tentative decisions to date

A1. The following table presents a summary of tentative decisions made in the redeliberations phase in 2014 and 2015:

	Tentative decisions	Change from 2013 Exposure Draft
1	***Targeted issue: Unlocking the contractual service margin*** (a) Differences between the current and previous estimates of the present value of expected cash flows and the risk adjustment related to future coverage and other future services should be added to, or deducted from, the contractual service margin, subject to the condition that the contractual service margin should not be negative. (b) Differences between the current and previous estimates of the present value of cash flows and the risk adjustment that do not relate to future coverage and other future services should be recognised immediately in profit or loss. (c) 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 related to coverage and other services to be provided in the future. (d) An entity should use the locked-in rate at inception of the contract for accreting interest and for determining the change in the present value of expected cash flows that offsets the contractual service margin.	The 2013 Exposure Draft would: • recognise all changes in estimates of risk adjustment immediately in profit or loss. • rebuild the contractual service margin from zero without first reversing previously recognised losses in the profit or loss.

<table>
<tr><th></th><th>Tentative decisions</th><th>Change from 2013 Exposure Draft</th></tr>
<tr><td>2</td><td>Targeted issue: Presentation of interest expense in the Statement of Comprehensive Income
(a) An entity should choose to present the effect of changes in discount rates in profit or loss, or in other comprehensive income as its accounting policy and should apply that accounting policy to all contracts within a portfolio
(b) If the entity chooses to present the effect of changes in discount rates in other comprehensive income, the entity should:
(i) Recognise in profit or loss, the interest expense determined using the discount rates that applied at the date that the contract was initially recognised; and
(ii) Recognise in other comprehensive income, the differences between the carrying amount of the insurance contract measured using the discount rates that applied at the reporting date and the carrying amount of the insurance contract was initially recognised.
(iii) Disclose an analysis of total interest expense included in total comprehensive income disaggregated at a minimum to:
1. interest accretion at the discount rate that applied at initial recognition of insurance contracts reported in profit or loss for the period; and
2. the movement in other comprehensive income for the period.</td><td>The 2013 Exposure Draft proposed that the effect of changes in discount rates should be required to be presented in OCI.</td></tr>
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	Tentative decisions	Change from 2013 Exposure Draft
	(c) An entity should disaggregate total interest expense included in total comprehensive income to: (i) the amount of interest accretion determined using current discount rates; (ii) the effect on the measurement of the insurance contract of changes in discount rates in the period; and (iii) the difference between the present value of changes in expected cash flows that adjust the contractual service margin in a reporting period when measured using discount rates that applied on initial recognition of insurance contracts, and the present value of changes in expected cash flows that adjust the contractual service margin when measured at current rates. (d) For contracts without participation features, an entity should use the locked-in rate at inception of the contract for accreting interest and for determining the change in the present value of expected cash flows that offsets the contractual service margin. (e) An entity should apply the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to changes in accounting policy relating to the presentation of the effect of changes in discount rates.	
3	***Targeted issue: Insurance contracts revenue*** (a) An entity should present insurance contract revenue and expense in the statement of	The 2013 Exposure Draft did not explicitly prohibit presenting premium information in the

	Tentative decisions	Change from 2013 Exposure Draft
	comprehensive income, as proposed in paragraphs 56–59 and B88–B91 of the 2013 Exposure Draft; and (b) An entity should disclose the following: (i) a reconciliation that separately reconciles the opening and closing balances of the components of the insurance contract asset or liability (paragraph 76 of the 2013 Exposure Draft); (ii) a reconciliation from the premiums received in the period to the insurance contract revenue in the period (paragraph 79 of the 2013 Exposure Draft); (iii) the inputs used when determining the insurance contract revenue that is recognised in the period (paragraph 81(a) of the 2013 Exposure Draft); and (iv) the effect of the insurance contracts that are initially recognised in the period on the amounts that are recognised in the statement of financial position (paragraph 81(b) of the 2013 Exposure Draft). (c) An entity should be prohibited from presenting premium information in the statement of comprehensive income if that information is not consistent with commonly understood notions of revenue.	statement of comprehensive income if that information is not consistent with commonly understood notions of revenue.
4	**Targeted issue: Transition** **(for contracts without participation features)** (a) an entity should apply the Standard retrospectively in accordance with IAS 8 unless	For contracts without participation features: • Simplified the practical

Tentative decisions	Change from 2013 Exposure Draft
impracticable; and (b) if retrospective application of the Standard is impracticable, an entity should apply the simplified approach proposed in paragraphs C5 and C6 of the 2013 Exposure Draft with the following modification: instead of estimating the risk adjustment at the date of initial recognition as the risk adjustment at the beginning of the earliest period presented, an entity should 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. (c) if the simplified approach described in paragraph (b) above is impracticable, an entity should: (i) determine the contractual service margin at the beginning of the earliest period presented as the difference between the fair value of the insurance contract at that date and the fulfilment cash flows measured at that date; and (ii) 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 method in the simplified approach proposed in paragraph C6(c) and (d) the 2013 Exposure Draft. (d) for each period presented for which there are contracts that were measured in	expedients when retrospective application in accordance with IAS 8 is impracticable. • In addition, added a way for the entity to estimate the contractual service margin on transition when neither retrospective application nor the simplified approach are impracticable. For initial application of the new standard after implementation of IFRS 9, the 2013 Exposure Draft did not allow or require an entity to reassess the business model for financial assets at the date of initial application of the new insurance contracts Standard.

	Tentative decisions	Change from 2013 Exposure Draft
	accordance with the simplified approach or the fair value approach, an entity should disclose the information proposed in paragraph C8 of the 2013 Exposure Draft (ie the disclosures for contracts for which retrospective application is impracticable) separately for: (i) contracts measured using the simplified approach; and (ii) contracts measured using the fair value approach. **(On initial application of the new insurance contracts Standard after implementation of IFRS 9 Financial Instruments)** (a) An entity is permitted to newly designate financial assets under the fair value option as measured at fair value through profit or loss to eliminate (or significantly reduce) an accounting mismatch according to paragraph 4.1.5 of IFRS 9; (b) An entity is required to revoke previous fair value option designations for financial assets if the accounting mismatch that led to the previous designation according to paragraph 4.1.5 of IFRS 9 no longer exists; and (c) An entity is permitted to newly designate an investment in an equity instrument as measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 and is permitted to revoke previous designations. (d) To provide further transition relief to permit or require an entity to reassess the business model for financial assets at the date of initial application of the new insurance contracts	

	Tentative decisions	Change from 2013 Exposure Draft
	Standard. This reassessment would be based on the conditions for assessing the business model in paragraphs 4.1.2(a) or 4.1.2A(a) of IFRS 9 and the facts and circumstances that exist at the date of the first application of the new insurance contracts Standard.	
5	***Non-targeted issue: Level of aggregation and portfolio definition*** (a) Clarify that the objective of the proposed insurance contracts Standard is to provide principles for the measurement of an individual insurance contract, but that in applying the Standard an entity could aggregate insurance contracts provided that it meets that objective. (b) Amend the definition of a portfolio of insurance contracts to be: "insurance contracts that provide coverage for similar risks and are managed together as a single pool". (c) Add guidance to explain that in determining the contractual service margin or loss at initial recognition, an entity should not aggregate onerous contracts with profit-making contracts. An entity should consider the facts and circumstances to determine whether a contract is onerous at initial recognition.	The definition of a portfolio in the 2013 Exposure Draft is modified to eliminate the reference to “priced similarly relative to the risk taken on”. The definition of portfolio now applies more narrowly than the 2013 Exposure Draft. Added additional guidance and clarification
6	***Non-targeted issue: Discount rate for long-term contracts when there is little or no observable market data*** (a) Confirm the principle that the discount rates used to adjust the cash flows in an insurance contract for the time value of money should be consistent with observable current market prices for instruments with cash flows whose characteristics are	Added clarification of how the principle should be applied in determining discount rates for insurance contracts.

	Tentative decisions	Change from 2013 Exposure Draft
	consistent with those of the insurance contract. (b) Provide additional application guidance that, in determining those discount rates, an entity should use judgement to: (i) ensure that appropriate adjustments are made to observable inputs to accommodate any differences between observed transactions and the insurance contracts being measured. (ii) develop any unobservable inputs using the best information available in the circumstances, while remaining consistent with the objective of reflecting how market participants assess those inputs. Accordingly any unobservable inputs should not contradict any available and relevant market data.	
7	***Non-targeted issue: Asymmetric treatment of contractual service margin between insurance contracts issued and reinsurance contracts held*** (a) After inception, an entity should recognise in profit or loss any changes in estimates of fulfilment cash flows for a reinsurance contract that an entity holds when those changes arise as a result of changes in estimates of fulfilment cash flows for an underlying direct insurance contract that are recognised immediately in profit or loss.	The 2013 Exposure Draft proposed that, for a reinsurance contract that an entity holds, all changes in estimates of fulfilment cash flows relating to future service should be recognised and offset to the contractual service margin

	Tentative decisions	Change from 2013 Exposure Draft
8	***Non-targeted issue: Allocation of the contractual service margin to the profit or loss*** ***(for contracts without participation features)*** (a) Confirm the principle in the 2013 Exposure Draft that an entity should recognise the remaining contractual service margin in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of the services that are provided under an insurance contract. (b) Clarify that, for contracts without participation features, the service represented by the contractual service margin is insurance coverage that: (i) is provided on the basis of the passage of time; and (ii) reflects the expected number of contracts in force.	The 2013 Exposure Draft stated only that an entity should recognise the remaining contractual service margin in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of the services that are provided under an insurance contract.
9	***Non-targeted issue: Significant insurance risk*** (a) Clarify the guidance in paragraph B19 of the 2013 Exposure Draft that significant insurance risk only occurs when there is a possibility that an issuer will incur a loss on a present value basis.	The 2013 Exposure Draft referred more specifically to the need for a scenario with commercial substance in which the present value of the net cash outflows can exceed the present value of the premiums.

10	***Non-targeted issue: Portfolio transfers and business combinations*** (a) Clarify the requirements for the contracts acquired through a portfolio transfer or a business combination in paragraphs 43-45 of the 2013 Exposure Draft, that such contracts should be accounted for as if they had been issued by the entity at the date of the portfolio transfer or business combination.	Clarification of requirements in the 2013 Exposure Draft to avoid difference in interpretation.
11	***Non-targeted issue: Fixed fee service contracts*** (a) Entities should be permitted, but not required, to apply the revenue recognition Standard to the fixed-fee service contracts that meet the criteria stated in paragraph 7(e) of the 2013 Exposure Draft.	The 2013 Exposure Draft excluded all fixed fee service contracts from its scope.
12	***Non-targeted issue: Premium-allocation approach*** (a) Clarify that when an entity applies the premium-allocation approach to account for an insurance contract, it should recognise insurance contract revenue in profit or loss: (i) on the basis of the passage of time; but (ii) if the expected pattern of release of risk differs significantly from the passage of time, then on the basis of expected timing of incurred claims and benefits. (b) When an entity applies the premium-allocation approach to contracts for which the entity: (i) discounts the liability for incurred claims; and (ii) chooses to present the effect of changes in discount rates in OCI; the interest expense in profit or loss for the liability for incurred claims should be	The 2013 Exposure Draft required that an entity should allocate the expected premium receipts as insurance contract revenue to each accounting period in the systematic way that best reflects the transfer of services that are provided under the contract. The 2013 Exposure Draft required that interest expense on insurance liabilities should be

	determined using the discount rate that is locked in at the date the liability for incurred claims is recognised. This tentative decision also applies to the presentation of interest expense for any onerous contract liability that is recognised when the entity applies the premium-allocation approach.	determined using the discount rates that applied at the date that the contract was initially recognised.
13	***Non-targeted Issues that will not be addressed*** (a) In April 2014 the IASB tentatively decided not to consider in future meetings other non-targeted issues, including those relating to: (i) disclosures; (ii) combination of insurance contracts; (iii) contract boundary for specific contracts; (iv) unbundling—lapse together criteria; (v) treatment of ceding commissions; (vi) discount rate—top-down and bottom-up approaches; (vii) tax included in the measurement; and (viii) combining the contractual service margin with other comprehensive income.	None

Appendix B: List of staff papers on participating contracts presented at education sessions to date

Year	Month	Paper	Title
2014	May	2A	Contracts with participating features: Background
2014	May	2B	Possible adaptations for contracts with participating features
2014	June	2D	The identification of underlying items
2014	July	2A	OCI mechanics for contracts with participating features
2014	September	2A	Book yield and effective yield approaches to presenting interest expense in profit or loss
2014	September	2B	Illustrative examples of book yield and effective yield approaches
2014	September	2C	Use of OCI for contracts with participating features
2014	September	2D	Should there be a book yield approach for determining interest expense in profit or loss?
2014	November	2	[Education session in which IASB considered a paper prepared by the European Insurance CFO Forum setting out its proposals for the accounting for contracts with participating features.]
2015	February	2A	Level of aggregation: application to contracts with participation features
2015	March	2A	Adaptations for insurance contracts that provide policyholders with investment returns: Background and scope
2015	March	2B	Adaptations for insurance contracts that provide policyholders with investment returns: Proposed accounting for CSM and OCI
2015	March	2C	Adaptations for insurance contracts that provide policyholders with investment returns: Recognition of contractual service margin in profit or loss
2015	May	2A	Application of the variable fee approach: Mutualisation
2015	May	2B	Application of the variable fee approach: Revenue; and
2015	May	2C	Application of the variable fee approach: Transition.
2015	May	2D	Proposed accounting for indirect participation contracts
2015	May	2E	Presentation of interest expense for contracts with participation features—whether to provide an accounting policy choice