STAFF PAPER

June 2015

IASB Meeting

Project	Insurance Contracts		
Paper topic	Variable fee approach for direct participation contracts		
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Purpose of this paper

1. This paper discusses whether the IASB should modify the general measurement model described in Agenda Paper 2A *Application of the general model to contracts with participation features* for some contracts with participation features. It:
   - (a) considers the arguments that the IASB should modify its general approach when an insurance contract can be viewed as creating an obligation to pay to policyholders an amount that is equal in value to specified underlying items, less a variable fee for service (paragraphs 3-12); and
   - (b) considers in what circumstances an insurance contract can be viewed as creating an obligation to pay to policyholders an amount that is equal in value to specified underlying items, less a variable fee for service (paragraphs 14-27).

Staff recommendations

2. The staff recommend:
   - (a) 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.

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

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

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

   (iii) 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.

Staff analysis

Should the general measurement model be modified for contracts with participation features?

Outcome of applying the general measurement model

3. Agenda Paper 2A describes how the IASB's general measurement model would apply for contracts with participation features. This paper considers whether the IASB should modify the way in which the general measurement model would depict the gains and losses that arise when an entity issues a contract with participation features.

4. In contracts with participation features, the net gain or loss that the entity receives as a result of issuing the contracts is a combination of the following factors:

   (a) the amount of premiums the entity charged the policyholder;

   (b) the payments that the entity will make that arise as a result of an insured event; and

   (c) the return on the premiums invested by the entity, and the proportion of those returns that the entity retains for its own benefit.

5. The IASB's general measurement model views the difference between the amount of premiums the entity charges and the payments the entity makes due to the occurrence of the insured event as the underwriting result. The investing result arises from the interest expense on the insurance contract and the effect of changes in discount rates. The statement of profit and loss would also reflect gains and losses retained by the entity that arise from the investment portfolio in which the premiums are invested. Such gains and losses would be recognised in profit or loss according to other applicable IFRSs.

6. Thus, in the IASB's general measurement model:

   (a) the entity's profit from investing activities arises from the difference between (i) the net gains and losses from the investments, and (ii) the net gains and losses that the entity passes to the policyholder through the participation mechanism which are recognised as changes in the insurance contract liability.

   (b) the net gains and losses that the entity retains from invested premiums are treated as if they were a share of economic returns from the investment portfolio, and the entity's share in the investment portfolio is accounted for in the same way as a standalone investment that the entity owns and controls.

7. The general measurement model reflects that the investment portfolio is controlled and owned by the entity, consistently with the following:

   (a) the policyholder is entitled only to a portion of the returns, and the remaining returns are due to the entity;

   (b) the entity controls the cash flows of the investments, and its primary aim is to increase its own share of those cash flows, even when the entity is required to act in a fiduciary capacity for the policyholder. That is the case even when an entity is required to pass to policyholders a substantial proportion of the variable returns from the investment portfolio.

   (c) in most cases, the entity has legal title for the investment portfolio, and retains the obligation to pay the policyholders the amounts that are determined on the basis of the investments in the portfolio, irrespective of the entity's investment strategy. Furthermore, an entity would be unlikely to have a legally enforceable right to set off the insurance contract liability with the investment portfolio, even if the investment portfolio were to be invested in assets which exactly match the entity's obligation.

8. Supporters of the general measurement model argue that depicting the gains and losses on the entity's share of the investment portfolio in the same way as a standalone investment would be appropriate, because it would reflect the entity's control of the investment portfolio. Furthermore, they argue that reporting the entity's interest in investment portfolio on a consistent basis with other investments controlled by the entity would result in more transparent and understandable reporting in primary financial statements of the changes in circumstances affecting both the investment portfolio and the entity's obligations to policyholders.

Proposed modification

9. Some argue that the returns to the entity arising from a participating contract should be viewed as part of the compensation that the entity charges the policyholder for service provided by the insurance contract, rather than as a share of returns from a standalone investment. They note that the premium the entity sets at inception factors in an estimate of the entity's share of returns at inception and the costs of providing the contract. Accordingly, they argue that changes in the estimate of the share should be regarded as a change in the entity's compensation for the contract. In their view, changes in the entity's compensation should be recognised over the periods in which the entity provides the service promised in the contract, in the same way that changes in the estimates of the costs of providing the contract are recognised.

10. Those with this view also note that any benefit the entity receives from its share of the investment portfolio arises only as a consequence of the entity holding those items on behalf of the policyholder. In addition, they also observe that the entity is often constrained from exercising its control over the investments because:

    (a) the quantum of investments is determined entirely from the premiums paid by the policyholder,

(b) the entity is usually expected to manage the policyholder's invested premiums for the benefit of the policyholder,

(c) the entity must generally follow the investment strategy specified in the contract, and

(d) the entity is usually required to act in a fiduciary capacity for the policyholder.

11. Because of these features, some believe that the entity's interest in the investment portfolio is not, in substance, the equivalent of a direct holding in assets, but is equivalent to a variable fee that the entity charges the policyholder, expressed as a share of returns. Applying this view:

(a) The entity's obligation to the policyholder is considered to be the net of:

(i) the obligation to pay the policyholder an amount equal to the fair value of the investment portfolio (referred to as 'underlying items') and

(ii) a variable fee that the entity deducts in exchange for the services provided by the insurance contract.

The staff notes that the underlying items are not the assets that the entity holds. Rather, they are referenced assets, on which the obligation is based.

(b) Changes in the estimate of the obligation to pay to the policyholder an amount equal to the fair value of the underlying items would be recognised in profit or loss or other comprehensive income, in the same way changes in the fair value of the underlying items.

(c) Changes in the estimate of the variable fee for future services would be accounted for in a way consistent with the changes in estimate relating to future service. Accordingly, such changes in estimates would be adjusted in the contractual service margin so that they would be recognised in future periods, rather than in the period in which they occur.

(d) The financial statements of the entity report a net investment return only to the extent that return on the assets the entity holds do not match the returns on the promised underlying items.

12. The staff note that, at inception, the variable fee for future services comprises the entity's share of the returns on underlying items less any expected cash outflows that do not vary directly with the underlying items, including those relating to the payment of guarantees over the returns on underlying items. As a consequence, this 'variable fee approach' would mean that changes in the value of any options or guarantees in the contract would be adjusted against the contractual service margin.

13. Supporters of the variable fee approach believe that depicting the gains and losses on the entity's share of the underlying items as a variable fee for service would be appropriate, because they think it reflects the nature of the contractual arrangement. Furthermore, they argue that reporting the entity's interest in underlying items in the same way as consideration for other contracts with customers would result in more transparent and understandable reporting in primary financial statements of the entity's obligations to policyholders. The fact that the variable fee is determined by reference to a share of the returns on the underlying items is incidental to its nature as a fee.

When the obligation is to pay the policyholder an amount equal to the value of the underlying items less a variable fee

14. If the IASB were to agree to modify its general measurement model as described in paragraphs 9-12, the question that arises is when the modification would apply. In other words, the IASB would need to set a scope.

15. The need to specify a scope arises because of different accounting outcomes between the general measurement model and the modified model. Those differences arise because, when the entity is viewed as earning a variable fee for service, it would offset in the contractual service margin the effect of its own exposure to variable underlying items. This would not be the case in the general approach, in which the contractual service margin is not adjusted for the effect of changes in the entity's exposure to those underlying items. Consequently,

viewing the entity's interest in underlying items as a fee for service will create a difference[1] in the way that insurance contracts are accounted for.

16. The primary argument for the modifications described in paragraphs 9-12 is that the entity's share of investment returns from underlying items should be considered to be a variable fee for service, rather than a direct economic interest in the underlying items. Accordingly, it follows that the scope should restrict the modifications to circumstances in which the entity's share of investment returns can be viewed as part of the variable fee for service.

17. In the staff's view, the entity's share of investment returns can be viewed as part of the variable fee for service if and only if all of the following conditions are met:

    (a) The contract specifies a determinable fee. For this to be the case the contract needs to specify that the policyholder participates in a defined share of a clearly identified pool of underlying items. This criterion is discussed further in paragraphs 18-20.

    (b) The entity's primary obligation is to pay to the policyholder an amount equal to the fair value of the underlying items (see paragraphs 21-27). For this to be the case:

        (i) The policyholder should be expected to receive an amount equal to a substantial share of the returns from the underlying items. In other words, the obligation cannot be regarded as being to pay an amount equal to the fair value of the underlying items if the policyholder does **not** expect to receive a substantial part of the total return from the underlying items.

        (ii) the policyholder should be exposed to a substantial portion of the variability in the value of the underlying items. In other words, a substantial proportion of the cash flows that the policyholder expects to receive should be expected to vary with the cash flows from underlying items.

[1] The staff expect to consider these differences, and whether they should be reduced, at a future meeting.

Determinable fee

18. Paragraph 17(a) proposes that a clearly determinable fee should be a condition for an approach in which the entity's obligation is viewed as being the payment to the policyholder of an amount equal to the value of the underlying items less a variable fee. Without a determinable fee, the share of returns from underlying items that the entity retains would be entirely at the discretion of the entity, and this would not be consistent with that amount being equivalent to a fee.

19. Paragraph 17(a) also specifies that a fee would be determinable only when the policyholder participates in a **defined share** of a **clearly identified pool of underlying items**. These conditions are needed to ensure that the compensation the entity receives has the characteristics of a fee, rather than of an economic interest which it shares with policyholders.

20. In the staff's view:

    (a) a defined share would exist only when the contract specifies the share that the entity may retain and the share that the policyholder must receive. A defined share does not preclude the existence of the entity's discretion to vary the amount that the entity retains in a way that results in the policyholder receiving a higher share of returns than specified in the contract.

    (b) a clearly identifiable pool of underlying items would not exist in the following cases:

        (i) When the entity can retroactively change the underlying items that determine the amount of the entity's obligation. The staff think that, if an entity is able to change the underlying items that determine its obligation, then an entity has, in effect, an obligation to pay a discretionary amount, rather than an amount that is based on specified items. Therefore, the staff think that an entity's ability to retroactively change the underlying items means that the obligation to the policyholder is not based on clearly identified items.

        (ii) When there are no underlying items identified, even if the policyholder could be provided with a return that generally reflects the entity's overall performance and expectations, or the performance and expectations of a subset of assets the entity holds. Such a return could be in the form of a crediting rate or dividend payment set at the end of the period to which it relates.[2] In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set, and not a defined underlying item.

Primary obligation is to pay to the policyholder an amount equal to the fair value of the underlying items

21. Paragraph 17(b) proposes that the entity's share of investment returns can be viewed as part of the variable fee for service only if the entity's primary obligation is to pay to the policyholder an amount equal to the fair value of the underlying items. That would be the case if:

    (a) The policyholder is expected to receive an amount equal to a substantial share of the returns from the underlying items; and

    (b) A substantial proportion of the cash flows that the policyholder receives is expected to vary with the cash flows from underlying items.

22. These conditions are intended to distinguish situations in which the investment returns should be viewed as being the policyholders', rather than the entity's. The staff observe the following features about these conditions:

    (a) The conditions rely on the entity's *expectations* at inception of the contract (see paragraphs 23-24).

    (b) The conditions rely on the entity's judgement to assess what is a substantial share of the returns and a substantial proportion of the cash flows. The staff think that a degree of judgement in this area is inevitable, unless the IASB specifies a bright line.

    (c) The conditions are assessed at inception of the contract and not subsequently reassessed (see paragraphs 25-26).

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[2] In contrast, if the crediting rate is set in advance, then the promise is determinable and referenced to an underlying item. For example, a fixed crediting rate is equivalent to underlying items being fixed rate bonds.

Expectations of cash flows

23. One consequence of conditions based on expectations is that the contracts that have a large discretionary element would be eligible for the variable fee approach, provided that the entity expects that the cash flows in the contract would equal a substantial share of underlying items and that a substantial proportion of those cash flows would vary with the underlying items. For example, the following two contracts would be eligible for the variable fee approach:

    (a) A contract in which the entity is required to pay to policyholders an amount equal to 90% of the returns on underlying items. In this case the contractual terms and the entity's expectations have the same effect.

    (b) A contract in which the entity is required to pay to policyholders an amount equal to 50% of the returns on underlying items, but the entity always expects to pay 90% of the returns on underlying items for competitive reasons. In this case, the contractual terms would result in 50% of the returns on the underlying items being paid to the policyholder, and the entity expects to exercise its discretion so that a further 40% of the returns on underlying items are paid to the policyholder.

24. The staff think it is appropriate to rely on the entity's expectations, rather than contractual terms and conditions. This is because the measurement of an insurance contract is based on the cash flows that the entity expects to arise as the entity fulfils the contract, regardless of whether the cause of the cash flow is contractual or discretionary.

Reassessment of eligibility for the variable fee approach

25. Another consequence of conditions that are based on expectations is that a contract that meets those conditions at inception of the contract might not meet them in later periods. For example, the presence of an in-the-money guarantee at inception, that is not expected to be out-of-the-money over the contract term, would mean that an entity might not meet the condition that the policyholders are expected to be exposed to a substantial portion of the variability of the asset returns. However, in some cases, circumstances can change after initial recognition such that a guarantee that the entity did not expect to become in-the-

money (and hence would meet the eligibility conditions) becomes in-the-money after initial recognition (and hence might not meet the eligibility conditions had the contract been assessed after initial recognition).

26. If the IASB were to require that an entity reassess eligibility for the variable fee approach at each reporting date, this would mean that a contract could start being accounted for using the variable fee approach, and then, partway through the contract term, change to being accounted for using the general measurement model. However, in general, the IASB does not require or permit reassessment after initial recognition, for example of the presence of significant insurance risk, or eligibility for the premium allocation approach. The staff think that the IASB's conclusion that continuous monitoring of whether a contracts meets eligibility criteria over the life of a contract would be too onerous remains valid, particularly given the subjective nature of some of the conditions. Accordingly, the staff propose that an entity should not reassess whether a contract remains eligible for the variable fee approach after inception.

Omitted criteria

27. The staff considered the following additional criteria, but concluded that they would not be necessary:

(a) The returns to be passed to the policyholder should arise from items the entity holds. The staff believe that this criteria is not necessary because an entity's obligation to pay the policyholder an amount equal to the value of the underlying items (less a fee) is not altered if the entity chooses to take risks by investing the premiums in items that are different from the specified underlying items. The staff observe that if the entity holds assets other than the underlying items, then the economic mismatch between the entity's assets and the obligation to the policyholder would be reported in the statement of comprehensive income.

(b) There should be a minimum amount that the entity must retain, ie that the fee should never be negative. The staff believe that this criterion is not necessary because:

(i) at inception, a contract with a negative fee would be recognised as an onerous contract.

(ii) losses that arise because the fee is not as expected are, in principle, no different to other losses that arise that were not originally expected.

Question to the IASB: Variable fee approach

Do you agree 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? The fee the entity expects to earn from the contract is 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.

Do you agree that contracts with direct participation features should be defined as contracts for which:

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

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

(iii) 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?