STAFF PAPER

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Project	Insurance Contracts		
Paper topic	Recognition of contractual service margin in profit or loss for contracts with participation features		
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Purpose of this paper

1. This paper considers considers the recognition of the contractual service margin in profit or loss for contracts with participation features, as follows:

    (a) backfround, including the proposals in the 2010 and 2013 EDs and the feedback received (paragraphs 3-10);

    (b) a discussion of the services provided by contracts with participation features (paragraphs 11-15); and

    (c) consideration of:

        (i) the pattern of delivery of investment-related service (paragraph 16-23)

        (ii) when contracts with participation features which include more than one service (paragraphs 24-33); and

        (iii) the need to reflect the number of contracts in force (paragraphs 34-35).

Staff recommendation

2. The staff recommendthat, 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.

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Background

2010 ED proposal and feedback received

3. The 2010 Exposure Draft *Insurance Contracts* (the 2010 ED) proposed that, for all insurance contracts, the residual margin (later renamed the contractual service margin) should be recognised:

    (a) on the basis of passage of time, but

    (b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

4. The Basis for Conclusions to the 2010 ED noted that the IASB's objective was to seek a release pattern that corresponds in a reasonable way and at an acceptable cost to the pattern of factors that generated the residual margin at initial recognition. The Basis for Conclusions acknowledged that because the residual margin blends various factors not separately identifiable, any such release pattern would inevitably be arbitrary. Because the risk adjustment reflects the risk in the contract, the IASB thought that risk should not drive the release pattern for the residual margin. Instead, the IASB decided to determine the release pattern for the residual margin on the basis of an insurer's performance under the contract. Since insurance coverage is present in every insurance contract, the IASB concluded that the insurance coverage could be used as the basis for release across all types of contracts.

5. For financial instruments with discretionary participation features, which do not provide insurance coverage but are within the scope of the proposed Standard, the IASB decided that the release of the residual margin should reflect the pattern of provision of asset management services, the primary service provided by these contracts, rather than the pattern of claims and benefits.

6. Many comment letters on the 2010 ED supported these proposals for the release pattern of the residual margin. However, some constituents believed that the proposed guidance was "unduly prescriptive" and that a more principle-based approach would be more appropriate.

2013 ED proposal and feedback received

7. After considering the feedback received on the 2010 ED, the IASB decided to state only the principle that the contractual service margin (the new name for the residual margin)

should be recognised in profit or loss over the coverage period in the systematic way that best reflects the remaining transfer of services that are provided under the contract. This would allow entities to decide that the primary service provided under the contract is not insurance coverage, as was assumed in the 2010 ED, but could be a different service, such as asset management service. The relevant paragraphs of the Basis for Conclusions to the 2013 ED are paragraphs BC26 and BCA109-BCA112.

8. Constituents responding to the 2013 ED supported the principle that the contractual service margin should be recognised in profit or loss in a systematic way to reflect the transfer of services provided under an insurance contract. However, many respondents stated that relying on a principle and providing little guidance would not be sufficient.

9. Accordingly, in May 2014, the IASB tentatively decided:

   (a) to confirm the principle that the contractual service margin should be recognised in profit or loss in a systematic way to reflect the transfer of services provided under an insurance contract, and

   (b) to add guidance that, for insurance contracts without participation features, the service represented by the contractual service margin is insurance coverage which:

      (i) is provided on the basis of the passage of time; and

      (ii) varies with the expected number of contracts in force.

10. The IASB noted it would consider separately the service provided by contracts with participation features. That is the purpose of this paper, which addresses both contracts with would meet the conditions for the variable fee approach described in Agenda Paper 2B, and those that would not.

Staff analysis

Service provided by contracts with participation features

11. All insurance contracts provide insurance coverage, and the IASB's conclusions on the pattern of delivery of insurance coverage applies equally to contracts with and without participation features. However, the distinguishing feature of contracts with participation features is that the contract provides policyholders with payments that vary with the

returns on assets.[1] Accordingly, many believe that insurance contracts with participation features provide investment-related services in addition to insurance coverage.

12. The staff note that the presence of investment-related *activity*, does not mean that the contract necessarily provides investment-related *service*. For example, consider an insurance contract in which the policyholder receives an accumulated fixed-rate guaranteed investment upon maturity, or a fixed death benefit if the policyholder dies before the maturity date. The entity must undertake investment-related activities to ensure it is able to provide that fixed return on maturity. However, that investment-related activity has no effect on the benefit ultimately paid to the policyholder, and therefore there is no investment-related service provided to the policyholder. Similarly, although contracts with participation features always provide policyholders with payments that vary according to investment returns, this does not mean that all such contracts provide the policyholder with investment-related service.

13. Agenda Paper 2B describes situations in which an insurance contract is considered to create an obligation to pay to the policyholder an amount equal to the value of the underlying items, less a variable fee for service. For these contracts, the contract provides both investment-related services and insurance coverage.

14. When an insurance contract does not create the obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee for service, the entity is considered to share in the economic returns from the underlying items. In those cases, arguably the entity does not provide investment-related services to the policyholder, but undertakes all investment-related activity for its own account and provides a discretionary return to the policyholder. The investment-related amount that the policyholder receives is not related to service, but is instead is a form of financial instrument, akin to a deposit and a derivative return. In such cases, the contract provides only one type of *service*, namely insurance coverage.

15. Applying the principle that the contractual service margin should be recognised in profit or loss in a systematic way to reflect the transfer of services provided under an insurance contract, the following questions arise:

    (a) What is the pattern of delivery of the investment-related services (and hence the appropriate pattern for the recognition of the contractual service margin

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[1] For simplicity, this paper refers to returns on assets. However, the analysis in this paper could be extended to refer to groups of specified assets and liabilities, or a pool of assets and liabilities including those that reflect other factors such as mortality gains and losses.

relating to investment-related services in profit or loss)? This is discussed in paragraphs **Error! Reference source not found.**-23.

(b) How should the contractual service margin be recognised when there is more than one type of service provided by the insurance contract? This is discussed in paragraphs 24-33.

Pattern of delivery of investment-related service

16. The staff observe that the investment-related services transferred to policyholders could be considered to be governed by a combination of:

    (a) the passage of time. In other words, more service is provided over six months than over three months.

    (b) the amount of assets under management. In order words, twice as much service is transferred when the investment-related activity relates to twice as many assets.

17. The staff believe that the provision of investment-related service is not related to:

    (a) the timing of when returns are distributed to policyholders or assigned to a policyholder's account balance. The essence of investment-related services is the increase in the value of the policyholder's economic interest in the underlying items. That increase in value occurs regardless of when the returns are distributed or assigned to policyholders.

    (b) the pattern of expected investment returns. The pattern of expected investment returns is only one factor that affects the amount of assets under management. In the staff's view, any investment-related service applies to the whole of the assets under management, and not just the part that arises from investment returns.

18. Treating investment-related services as delivered on the basis of the passage of time has the advantages that:

    (a) it reflects that the policyholder receives and consumes the benefits of the service continuously over time, and

    (b) it eliminates the issue of how to deal with contracts that provide more than one service (discussed in paragraphs 24-33). This is because the transfer of insurance coverage is also on the basis of the passage of time.

19. However, some believe that allocating the contractual service margin on the basis of the passage of time could be considered to overstate the fee earned in the early years of a contract, and understate the fees earned in the later years of a contract, compared to a percentage fee that might be charged by an asset manager who is not an insurer. This is because, in many contracts with participation features, the entity receives a regular premium each period, and so the aggregate investment increases both as a consequence of investment returns, and as a consequence of premium receipts over the contract term. This effect arises because the insurance contract model defines a contract boundary that reflects the entity's view of how the policyholders will exercise options available to them, such as renewal or surrender options, and determines the contractual service margin in a way that reflects the present value of all the fees that the entity expects to earn within the term of that boundary. In contrast, a non-insurance traditional asset manager would likely consider a considerably shorter time period in determining fees.

20. Allocating the contractual service margin on the basis of the passage of time would portray the entity as performing an equivalent amount of service in each period, even though the assets under management increase over time. In other words, it would portray the asset management service as being delivered on a level basis over the whole of the contract term. In contrast, an asset manager would earn the fee period by period.

21. Accordingly, some would prefer to regard investment-related services as delivered on the basis of the assets under management, because doing so has the following advantages:

    (a) It would be more consistent with the standalone selling price for asset management services, which are generally on the basis of the fair value of assets under management. This would be consistent with the view that the contractual service margin recognised in each period should be the amount that would have been charged for each period's service if it had been issued as a standalone contract.

    (b) It would be consistent with the reporting of most non-insurance asset managers, which generally recognise revenue based on the fair value of assets under management, even though this does not necessarily reflect the pattern of costs incurred.

22. If the IASB were to regard investment-related service as delivered on the basis of assets under management, then the contractual service margin would, in effect, be allocated in a way that reflects changes in the fair value of assets managed by the entity in each period. Such changes would include the investment returns or additional premiums paid by the

policyholder that affect the relative amount of investment-related service provided in each period.

23. The staff note that some comment letters on the 2010 ED thought that the transfer of asset management services should not reflect the fair value of assets under management when the entity manages and measures the underlying assets at amortised cost. However, the staff view the service to the policyholder as the increase in the value of the policyholder's economic interest in the underlying items, and this is not affected by the way that the entity measures the underlying assets.

Considerations for contracts with participation features which include more than one service

24. When an insurance contract provides investment-related services to a policyholder, there is more than one type of service provided in that contract. The question that then arises is how the transfer of those different services, with different patterns of provision, should be reflected in the allocation pattern for the contractual service margin for the contract as a whole.

25. Determining the allocation pattern for the contractual service margin is complicated by the fact that the relative amount of the insurance coverage and investment-related services might vary between different insurance contracts, and the relative amount of each type of service might also vary over the contract term. For example:

    (a) In a product with a guaranteed annuity option, the entity provides predominantly asset management service during the accumulation phase before the option is exercised. This is because the value of the assets at the date the annuity option is exercised affects the amount the policyholder will receive. After the option is exercised, the entity generally no longer provides asset management services (because the policyholder is no longer affected by asset management decisions) and provides only insurance coverage.

    (b) In a regular premium contract with an account balance and a fixed death benefit the entity provides insurance coverage until the premiums accumulated in the account balance exceed the amount of the fixed death benefit. During the accumulation phase, the insurance coverage provided is the difference between the fixed death benefit and the amounts accumulated in the account balance. That amount decreases over time. In contrast, the asset management services increase as the account balance increases.

26. The most correct approach would be to recognise in each period the contractual service margin according to the contribution each service makes to the contractual service margin in that period. However, the staff note that any distinct services would already have been separated from the insurance contract, in accordance with the requirement in paragraph 10(c) of the 2013 ED. Paragraph 10(c) would require an entity to separate any distinct performance obligation to provide services from the insurance contract and account for it using IFRS 15 *Revenue from Contracts with Customers*. Furthermore, paragraphs B34 and B35 of the 2013 ED state:

> B34 Subject to paragraph B35, a performance obligation to provide a good or service is distinct if either of the following criteria is met:
>
> (a) the entity (or another entity that does or does not issue insurance contracts) regularly sells the good or service separately in the same market or same jurisdiction. […]
>
> (b) The policyholder can benefit from the good or service either on its own or together with other resources that are readily available to the policyholder, Readily available resources are goods or services that are sold separately (by the entity or by another entity that might not issue insurance contracts), or resources that the policyholder has already obtained (from the entity or from other transactions or events).
>
> B35 A performance obligation to provide a good or service is not distinct if the cash flows and risks associated with the good or service are highly interrelated with the cash flows and risks associated with the insurance components in the contract, and the entity provides a significant service of integrating the good or service with the insurance components.

27. Therefore, an insurer is already required to unbundle distinct services, and those services that remain bundled are highly interrelated and integrated with each other. The staff believe that it would not be practical to further separate services that are not unbundled, other then on an arbitrary basis.

28. Accordingly, the staff believe that an entity should select a single driver to allocate the contractual service margin to profit or loss over the term of the contract. The staff believe that this would be consistent with the requirement in paragraph 30 of IFRS 15 that "if a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods and services that is

distinct. In some cases, that would result in the entity accounting for all the goods and services promised in a contract as a single performance obligation." The entity would then measure the entity's progress in satisfying that performance obligation by applying a single method of measuring progress for each performance obligation satisfied over time (paragraph 39 and 40 of IFRS 15).

29. Many suggest that the single driver for allocating the contractual service margin should be the predominant service provided by the contract. However, it can be difficult to assess the predominant service of an insurance contract overall. This is because the relative importance of the services in an insurance contract is likely to vary over time thus the predominant service will change between reporting periods. Furthermore, because the contractual service margin is adjusted to reflect changes in estimates relating to both insurance coverage and investment-related services, the contribution to the contractual service margin from the different services will vary over time.

30. Thus, determining the allocation pattern based on the predominant service at inception may mean that the amount of contractual service margin recognised in any given period bears little relationship to the amount of service provided in that period. In addition, in the examples in paragraph 25:

    (a) Recognising the contractual service margin on the basis of the assets under management for a product with a guaranteed annuity option would reflect the growth of the assets during the accumulation phase. However, after the annuity option is exercised, the entity provides only insurance coverage, and continuing to recognise the contractual service margin as if the contract provided asset management services would not reflect the economics of the contract. The staff note that when returns are stable, the outcome may be similar to recognising the remaining contractual service margin on the basis of the passage of time. However, volatility in asset values may have a different outcome.

    (b) Recognising the contractual service margin on the basis of the assets under management for a regular premium contract with an account balance and a fixed death benefit would depict the entity as providing very little service in the early years of a contract, and the majority of the service in later years. In contrast, the entity would provide the majority of the insurance coverage service in the early years of the contract, and little or no insurance coverage in the later years. A predominant component approach determined at inception would not reflect the interrelationship between these two types of service.

31. On the other hand, requiring entities to reassess the predominant service used to allocate the contractual service margin in each period could introduce considerable operational complexity. Accordingly, the staff think that a predominant service approach to allocating the contractual service margin is problematic.

32. Furthermore, in determining how an entity should measure the pattern of transfer of the combined services over the whole of the contract life, the staff observe that:

    (a) When an insurance contract creates an obligation to pay to the policyholder an amount equal to the value of the underlying items less a variable fee, that variable fee is the consideration for all the services provided by the insurance contract over the whole of the contract term. Those services are interrelated and may contribute to differing degrees over the contract term. The policyholder receives the interrelated services from the contract as a whole over time.

    (b) The only non-arbitrary way to allocate the contractual service margin determined at inception is to recognise the contractual service margin relating to each component according to the pattern of delivery of that component. However, because any separation of the services provided in an insurance contract is arbitrary (see paragraph 27), any allocation of the contractual service margin is likely to be arbitrary.

    (c) Regarding investment-related services as being delivered only on the basis of the passage of time would mean that the same allocation pattern could be applied for both the insurance coverage service and the investment-related service in the contract.

33. Accordingly, although feedback indicates significant concerns from many sources about recognising the contractual service margin for contracts with participation features on the basis of the passage of time (see paragraph 19), the staff think that the least complex and subjective approach would be to require entities to recognise the contractual service margin for all insurance contracts on the basis of the passage of time.

Reflecting the number of contracts in force

34. For non-participating contracts, the IASB decided that the recognition of the contractual service margin in profit or loss would need to reflect the expected number of contracts in force. This is because, for a portfolio of contracts, an entity would expect to transfer more insurance coverage service (and hence to recognise a greater proportion of the

contractual service margin in profit or loss) in the early years of the coverage period for a group of contracts, if it expects a significant proportion of insurance contracts to terminate before the end of their term, whether due to death, claims or lapses.

35. In the staff's view, this rationale applies equally to contracts with participation features. However, the staff also note that the objective of the proposed insurance contracts Standard is to provide principles for the measurement of an individual insurance contract and that, in meeting that objective, an entity would already need to ensure that the allocation pattern of the contractual service margin reflects the expected number of contracts that would be in force. Therefore, it would not be necessary to state the the contractual service margin should be recognised in profit or loss in a way that reflects the expected number of contracts in force. The staff note that the IASB's previous decision for the premium allocation approach already reflects this thinking.

Question to the IASB
Do you agree 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?