

STAFF PAPER

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Project	Insurance Contract		
Paper topic	Residual Margin – Accretion of Interest		
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Introduction

1. This paper discusses whether an insurer should be required to accrete interest on the residual margin.
2. This paper:
 - (a) sets out the proposals in the exposure draft *Insurance Contracts* (the ED) (paragraphs 5 - 6);
 - (b) provides an overview of the responses to those proposals (paragraphs 8 - 12); and
 - (c) presents a staff analysis and recommendation (paragraphs 13 - 14).
3. This paper does not discuss:
 - (a) which rate should be applied when accreting interest, which we discuss in Paper 16C; and
 - (b) accretion of interest under the premium allocation approach (PAA), which we will discuss at a future meeting.

Staff recommendation

4. The staff recommends that the IASB confirm the proposal in the ED that an insurer should accrete interest on the residual margin.

Proposals in the Exposure Draft

5. The ED proposed that an insurer should:
 - (a) recognise a residual margin that eliminates any gain at inception of the insurance contract;
 - (b) accrete interest on the carrying amount of the residual margin.
6. As explained in the basis for conclusions, the IASB decided to accrete interest on the residual margin for the following reasons:
 - (a) The residual margin can be viewed as an allocation of part of the consideration received from the policyholder. Accreting interest on the consideration paid is consistent with the proposals of the ED for *Revenue from Contracts with Customers*. It ensures that revenue is recognised at an amount that reflects what the cash selling price would have been if the customer had paid cash for the promised services at the point that they are transferred to the customer¹.
 - (b) The residual margin is a component of the measurement of the insurance contract. All the other components of the insurance contract reflect the time value of money. Consequently, accreting interest on the residual margin is consistent with this approach.
7. The FASB in their discussion paper (DP) proposed not to accrete interest on the composite margin on the grounds of simplicity and because the FASB views the margin as a deferred credit rather than as a component of an obligation.

¹ The IASB and FASB will discuss the accretion of interest on revenue during the September 2012 meeting (Agenda papers 7). The staff intends to recommend that the principle of accretion remain in the draft Revenue standard, but is recommending simplifications.

Responses to proposals in the ED

8. The ED asked respondents whether they agreed with the proposal that an insurer should accrete interest on the residual margin.
9. Fewer than half of respondents addressed this question specifically. Of those that responded, views were mixed regarding the benefits of accreting interest on the residual margin.
10. The respondents that supported accretion argued that:
 - (a) Accreting interest on the residual margin is consistent with the measurement of the other components of the insurance contract liability on a present value basis.
 - (b) Many insurance contracts, in particular life contracts, are long-term contracts. If interest is not accreted on the residual margin, the amount recognised as income in future periods would be understated.
 - (c) The net investment margin is overstated if interest is not accreted on the residual (This is illustrated in Appendix B).
11. Those respondents that did not support accretion were in two main groups:
 - (a) The first group agreed that accreting interest is conceptually consistent with the measurement model. However, they think that the complexity involved in practice outweighs the benefits of such an approach. For example, the tracking of the interest accreted and released would be complex, particularly if the residual is unlocked for changes in expected future cash flows. Determining which interest rate to apply is also complex as the residual margin represents a blend of different cash flows.
 - (b) The second group disagreed conceptually with the accretion of interest on the residual margin. These respondents argued that accretion of interest on the residual margin is:
 - (i) arbitrary because the amounts accreted do not result in actual cash flows. In addition, some respondents believe

that accreting interest on what they view to be a plug that eliminates day one profits is arbitrary;

- (ii) artificial, because accreting interest would increase the residual margin. The increase in the residual margin would then be released to profit or loss in future periods. This would increase the residual margin in early periods and release more of the residual margin to profit and loss in subsequent periods. They did not consider this to be meaningful.

12. The appendix to this paper provides a simple example to illustrate the impact of accretion and helps to explain the main arguments for and against accretion.

Staff recommendation

13. The staff recommend that an insurer should be required to accrete interest on the residual margin because:
- (a) Accreting interest on the residual margin is consistent with the treatment of the other components of the insurance liability. The insurer recognises the effect of discounting on the other components of the insurance liability in profit or loss.
 - (b) The residual margin is the difference between two discounted amounts (the present value of the cash inflows and the present value of the cash outflows). Consequently, the residual margin is itself implicitly discounted.
 - (c) If interest is not accreted on the residual margin, the total profit recognised on an insurance contract, taking into account the time value of money, declines over time. Given the long-term nature of many insurance contracts, eg life insurance, the impact of the time value of money can be significant. Residual margins released in 20 years' time may have little value, if any, if interest is not accreted on the residual margin.
 - (d) At the October 2011 meeting, the boards tentatively decided to require insurers to present premiums and claims/benefits in the

income statement. One way of presenting this information would require ‘premiums’ to be presented in the income statement at the cash amount received plus interest accreted on the insurance contract liability up to the time when coverage is provided (discussed at an education session in June 2012 and will be discussed again at a future meeting). Under this alternative, if interest has been accreted on the whole amount of the liability (including the residual margin), the amount presented as ‘premiums’ is easily explained: it is the present value of the premiums received and receivable at the time the coverage is provided. However, if interest is accreted on only part of the liability, the amount presented as ‘premiums’ is less easily explained or meaningful: it is somewhere in between the cash amount received or receivable and the present value at the time coverage is provided.

14. The staff acknowledges that accreting interest on the margin will increase complexity. However, staff thinks that accreting interest will result in more useful information..

Question 1 – Accretion of interest on residual margin

Does the IASB agree that an insurer should accrete interest on the residual margin?

Appendix A: Impact of accretion on profit or loss

A1. The simple example below illustrates how the accretion of interest on the residual margin could impact the profit or loss of an insurer. The assumptions are as follows:

- (a) at inception, a residual margin of CU5 000 is recognised on a portfolio of 5-year insurance contracts. An upfront premium of CU12 000 is received and estimated net present value of expected cash flows is CU7 000.
- (b) there are no changes in assumptions, and no changes in discount rates.
- (c) The discount rate of the liability is 5% and assumes a flat yield curve.
- (d) services are delivered evenly over the 5-year period.

A2. Using the assumptions,

- (a) Approach 1 illustrates the impact on profit or loss if interest is not accreted on the residual margin.
- (b) Approach 2 illustrates the impact on profit or loss if interest is accreted on the residual margin.

Approach 1—No accretion of interest						
	Y1	Y2	Y3	Y4	Y5	Total
Amount of residual released to profit or loss for the period	1 000	1 000	1 000	1 000	1 000	5 000
Impact on profit or loss for the period	1 000	1 000	1 000	1 000	1 000	5 000

A3. Under approach 1 the total residual margin of CU5 000 would be recognised equally over the five years (CU1 000 in each year).

Approach 2—Accretion of interest

Assume now that the insurer accretes interest at 5% per annum on the margin.

In order to reflect the fact that services are provided evenly over the 5-year period, the insurer annuitises the amount of the margin recognised in each period.

The insurer would release the residual margin as follows:

	Y1	Y2	Y3	Y4	Y5	Total
Amount of residual released to profit or loss for the period (A)	1 155	1 155	1 155	1 155	1 155	5 775
Amount of interest expense recognised due to the accretion of interest on the residual margin (B)	(250) ¹	(205) ²	(158) ³	(107) ⁴	(55) ⁵	(775)
Impact on profit or loss for the period [C = A – B]	905	950	997	1 048	1 100	5000

The interest was calculated as follows

- 1 $5\,000 \times 5\%$ 4 $(3\,145 + 158 - 1\,155) \times 5\%$
- 2 $(5\,000 + 250 - 1\,155) \times 5\%$ 5 $(2\,148 + 107 - 1\,155) \times 5\%$
- 3 $(4\,095 + 205 - 1\,155) \times 5\%$

A4. The following compares the effects of accreting interest (Approach 2) and not accreting interest on the margin (Approach 1) on profit or loss:

- (a) Both accreting and not accreting interest result in the same total impact on net profit or loss over the 5-year period (CU5 000).
- (b) Accreting interest on the margin results in additional interest expense recognised (totalling CU775 over the 5-years) and the total residual margin increases by a corresponding CU775.

(c) All things being equal, accreting interest results in an insurer presenting an increase (or a smaller decrease) in net profitability over time.

- A5. As discussed in paragraph 11(b)(ii), those that do not support accretion of the residual margin believe that the additional interest expense recognised (totalling CU775 over the 5-years) and the resulting grossing up of the residual margin by the same amount is artificial and question its usefulness because those amounts do not correspond to actual cash flows.
- A6. As discussed in paragraph 13, those that support accreting argue that the net impact recognised in profit or loss (Row C of Approach 2) is a better reflection of the impact of the time value on the residual margin. Put another way, the resulting pattern of income and expenses reflects what would have happened if the policyholder had paid the part of the premium representing the residual margin in equal annual instalments, and if the pricing of the contract had been adjusted to reflect that fact.
- A7. On the statement of financial position, accreting interest on the residual margin will result in a larger insurance liability when compared to not accreting. This would be consistent with the view that the policyholder implicitly places an interest-bearing deposit with an insurer and uses the deposit each period to pay for the part of the premium representing the residual margin for that period.
- A8. In evaluating the two approaches, the impact of investment returns and the interest expense on the liability should also be considered. This is illustrated further in Appendix B.

Appendix B – Illustrating further the effect of accretion

- A9. Using the same assumptions as in Appendix A (included below for convenience), this appendix illustrates further the effect of accreting interest by considering:
- (a) the interest expense recognised for discounting the cash flows; and
 - (b) investment income.
- A10. The assumptions are as follows:
- (a) at inception, a residual margin of CU5 000 is recognised on a portfolio of 5-year insurance contracts. An upfront premium of CU12 000 is received and estimated net present value of expected cash flows is CU7 000.
 - (b) there are no changes in assumptions, and no changes in discount rates.
 - (c) the discount rate of the liability is 5% and assumes a flat yield curve.
 - (d) upfront premiums are invested at a rate of 7% and interest is paid annually.
 - (e) the premium collected and interest received pays for the claims which occur at the end of each year during the 5-year coverage period.
 - (f) services are delivered evenly over the 5-year period.
- A11. The following table illustrates the effects if the insurer does not accrete interest on the residual margin.

Approach 1—No accretion of interest

	Y1	Y2	Y3	Y4	Y5	Total
Amount of residual released to profit or loss for the period [A]	1,000	1,000	1,000	1,000	1,000	5,000
Investment return [B]	840	694	538	370	190	2,633
Unwinding of discount on expected cash flows [C]	(350)	(287)	(220)	(150)	(77)	(1,084)
Net investment income [D= B – C]	490	407	318	220	115	1,550
Impact on profit or loss for the period [E=A + D]	1,490	1,407	1,318	1,220	1,115	6,550
Net investment income as a percentage of net profit % =D/E	33%	29%	24%	18%	10%	
Assets [F]	12,000	9,913	7,680	5,291	2,735	
Net investment margin [Net investment income/assets=D/F²]	4.08%	4.11%	4.14%	4.16%	4.20%	

A12. The net investment margin (representing the net investment return, after deducting interest expense, as a percentage of the invested assets) is approximately 4%. This is significantly higher than the actual investment spread of 2% (i.e. the difference between the return on assets of 7% and the interest expense on the liability of 5%).

² Because the claims are settled only at the end of the year, the assets are available for the entire year to earn interest

A13. Net investment income as a percentage of net profit, declines steeply over the period from 33% to 10%.

A14. The following table illustrates the effect if the insurer accretes interest on the residual margin.

Approach 2 - Accretion of interest ³						
	Y1	Y2	Y3	Y4	Y5	Total
Amount of residual released to profit or loss for the period [A]	1,155	1,155	1,155	1,155	1,155	5,775
Investment return [B]	840	694	538	370	191	2,633
Unwinding of discount on expected cash flows [C]	(350)	(287)	(220)	(150)	(77)	(1,084)
Accretion of interest on the residual margin [D]	(250)	(205)	(157)	(107)	(55)	(774)
Net investment income [E= B – C -D]	240	202	161	113	59	775
Impact on profit or loss for the period F = [A + E]	1,395	1,357	1,316	1,268	1,214	6,550
Net investment income as a percentage of net profit =E/F	17%	15%	12%	9%	5%	12%
Assets [G]	12,000	9,913	7,680	5,291	2,735	
Net investment margin [[Net investment income =E/G]	2.00%	2.04%	2.10%	2.14%	2.16%	

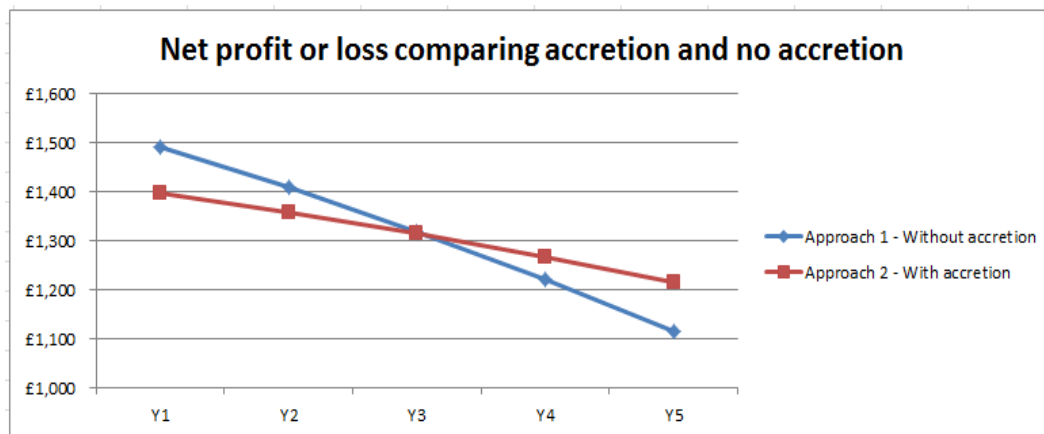
A15. The net investment margin when the margin is accreted is approximately 2%. In the example, the difference between the rate used to discount the liability (ie

³ Small differences can occur due to rounding

5%) and the return earned on the assets (ie 7%) is also 2%. Accretion results in a net investment margin which is a better reflection of the spread being earned. As discussed in paragraph A12, when the margin is not accreted, the net investment margin is approximately 4% which overstates the spread being earned.

- A16. Net investment income as a percentage of net profit declines less over the period, when compared to no accretion, from 17% to 5%.
- A17. The following graph compares the net profit or loss when the margin is accreted and not accreted:

Graph 1: Net profit or loss comparing accretion and no accretion



- A18. Not accreting the margin, results in a steeper slope in the trend of net profits over time because it is more responsive to the investment returns (ie net investment return is a greater proportion of net profit) than when the margin is accreted.