IFRS 17
Insurance Contracts

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National Bank of Ukraine

THE WORLD BANK
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Швеція
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1

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2

Introduction
IFRS 17 Insurance Contracts

May 2017

IFRS® Standards

IFRS 17 Insurance Contracts

IASB ❋IFRS

» IFRS 17
  » replaces an interim Standard—IFRS 4
  » requires consistent accounting for all insurance contracts based on a current measurement model
  » will provide useful information about profitability of insurance contracts
» Effective 2023
  » one year restated comparative information
  » early application permitted

3

3

Life insurance

4

Separation of contracts

5

Distinct investment component
Separation of contracts

Life insurance contracts, as a rule, have an <u>investment component</u>: additional income from the investment of reserve funds and a guaranteed income (no more than 4%).

Is it necessary to separate such components?

If separated, <u>by what rules should they be accounted</u> for?

» See next slide

6

6

Distinct investment component
Separation of contracts

Can only be separated if it is a **distinct** investment component

» An investment component is distinct if:
  » The investment and insurance components are not highly interrelated, and
  » An equivalent contract is sold or can be sold separately in the same market

» Investment and insurance components are highly interrelated if:
  » You cannot measure one without considering the other, or
  » The policyholder cannot benefit from one without the other

Week 7, Question II.2

7

7

Example
Distinct investment component

Non-distinct investment components	Comments
Life contract with surrender value linked to investment account	Component can only be measured by reference to other component (eg high likelihood of claim affects measurement of investment)
Pension contract with investment based accumulation	Investment component determines insurance risk, policyholder can only benefit from one with the other
Life contract with linked investment, client receives the higher of the two values	Component can only be measured by reference to other component

Week 7, Question II.2

8

8

4

Example
Distinct investment component

Is the contract insurance?

Yes

Does it contain an investment component?

No → Apply IFRS 17 to whole contract

Yes

Is the investment component distinct?

No → Apply IFRS 17 to whole contract

Yes → Apply other IFRS (9?) to contract

No → Apply other IFRS (9?) to contract

Does that IFRS require bifurcation?

Yes → Is the contract insurance?

Week 7, Question II.2

9

9

Cash flows

10

Policy loans

Could you tell more about <u>credits granted to clients</u>.

» Policyholder loans are are included in cash flows

» Policyholder loans meet the definition of cash flows arising from the insurance contract, and consequently are accounted as any other cash flows:

  » Present value of expected future cash flows

  » Adjusted in each period for time value of money, new information and experience adjustments

Week 6, Question 1.1

11

11

Policy loans
Scope of cash flows

<u>Scope</u> of cash flows:

» IFRS 17 defines an insurance contract (IFRS 17 definitions)

» IFRS 17.10-12 deal with what to separate out

» IFRS 17.13 states that IFRS 17 is applied to all remaining components of a contract after separating out

» IFRS 17.33 and 34 define the measurement of insurance contracts to include all future cash flows within the boundary, cash flows within the boundary are those that arise from rights and obligations that arise from the contracts

Week 6, Question 1.1

12

12

Policy loans
Scope of cash flows

Scope of cash flows (continued):

» IFRS 17.B65 provides examples of cash flows within the boundary including:

» Premiums, claims and benefits ((a),(b) and (c))

» Claims handling costs, administration and maintenance costs, transaction based taxes and an allocation of fixed and variable overheads ((f), (h), (i) and (l))

» IFRS 17.B66 provides examples of cash flows excluded:

» Cash flows from reinsurance contracts held;

» Costs that cannot be directly attributed

Week 6, Question 1.1

13

13

Policy loans

Questions to ask:

» Does the policyholder have the right to receive a policy loan included or implied by the insurance contract?

» Is the value of cash flows and claims under the insurance contracted impacted by the policy loan?

» Would these rights and obligations have arisen if the insurance contract was not issued?

> These questions establish **if** there is a right or obligation, and if so,
>
> **if** that right or obligation arises from the contract

Week 7, Question III.1

14

14

Policy loans

What is the trigger to <u>recognize them separately according</u> to IFRS 9 or in the insurance liability according to IFRS 17?

» Whether the cash flows arise from the insurance contract

» Whether they are 'separable'

Week 6, Question 1.2

15

15

Policy loans
Separation

» My view: This will very seldom reflect the requirements of IFRS 17 for separation

» Policy loans are typically highly interrelated with insurance contract:
  » Can only be granted if policyholder has an insurance contract
  » If policyholder defaults on one obligation, it affects rights under the other
  » Claims are usually adjusted to reflect outstanding balance of loan
  » etc

18

18

Policy loans
Measurement and accounting

How to <u>account and present it when it is granted</u> to the client? How to account the <u>accrued interest</u>? How to account it <u>after it has been repaid</u>? <u>What if not repaid</u>? Credits are <u>provided on different terms</u>. The policyholder does not pay some premium instalments and the insurance sum diminishes for the same amount. The client has the right to repay all the sums he/she has not yet payed and therefore the insurance sum will be increased back. Sometimes the client does not have the right to repay the previous premiums, so the insurance sum will remain unchanged when he/she starts to pay.

» These are all treated as parted of expected and actual cash flows under IFRS 17

» The extent of optionality indicated above suggests that these flows are not separable from the insurance contract

Week 6, Question 1.3

19

19

Surrender values

Life insurance contracts provide for the poli<u>cyholder's right to receive a redemption amount</u> in the event of early termination of the contract. <u>How to qualify and take this into account</u> from the point of the IFRS 17?

» Present value of probability weighted future cash flows

» True up of liability to reflect changes in probability, experience adjustments and time value of money

Week 7, Question II.3

20

20

Accounts receivable and payable

How to correctly account a/c receivable/payable under insurance/reinsurance contracts according to the IFRS 17 (what is the impact on liabilities/assets)?

» Included in present value of future cash flows

» A single net asset or liability is reflected for the group of insurance contracts

Week 7, Question III.1

21

21

Accounts receivable and payable

Questions to ask:

» Does the insurer have the right to receive or the obligation to pay amounts?

» Would either this right, or this obligation, have arisen if the insurance contract was not issued?

These questions establish **if** there is a right or obligation, and if so,

if that right or obligation arises from the contract

Week 7, Question III.1

25

25

Income statement

26

Experience adjustments

IFRS 17 requires to present experience adjustments. They appear because of two reasons: adjustments of real incurred claims in the period and adjustments of premiums in the period. What changes in premiums should have happened in order to be presented as experience adjustments? Could it be less/more premiums received than previously estimated or something else? How to account it? Should we decrease/increase the LRC when the expected premiums are not paid/already paid? How do we present it in P&L?

See next slide

Week 6, Question 2

27

27

Experience adjustments
Definition

» Experience adjustments is defined as:

A difference between:

(a) *for premium receipts (and any related cash flows such as insurance acquisition cash flows and insurance premium taxes)—the estimate at the beginning of the period of the amounts expected in the period and the actual cash flows in the period; or*

(b) *for insurance service expenses (excluding insurance acquisition expenses)—the estimate at the beginning of the period of the amounts expected to be incurred in the period and the actual amounts incurred in the period.*

Week 6, Question 2

28

28

Experience adjustments
Accounting

B96 *For insurance contracts without direct participation features, paragraph 44(c) requires an adjustment to **the contractual service margin** of a group of insurance contracts for changes in fulfilment cash flows that relate to future service. These changes comprise:*

(a) *experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the discount rates specified in paragraph B72(c).*

B97 *An entity shall not adjust the contractual service margin for a group of insurance contracts without direct participation features for the following changes in fulfilment cash flows because they do not relate to future service:*

(c) experience adjustments, except those described in paragraph B96(a).

Week 6, Question 2

29

29

12

Example
Experience adjustments: Unexpected lapses

» In current period insurer expects premiums of $1 000 from a group

» However, due to unexpected lapses, it only receives premiums of $750

» The unexpected lapses have no effect on future cash flows

» The insurer expected and paid claims of $600

» The insurer expected to release CSM of $400 in the period

Week 6, Question 2

30

30

Example
Experience adjustments: Unexpected lapses

	Debit	Credit
Cash received	750	
Insurance liability		750
Accounting for cash received		
Revenue (experience adjustment) (applying B97(c))	250	
Insurance liability		250
Accounting for the experience adjustment		
CSM	400	
Claims expense	600	
Revenue (expected)		1 000
Accounting for CSM release and P&L presentation		

31

31

13

Example
Experience adjustments: Unexpected lapses

Income statement (Debit)/Credit	2023
Revenue (Expected: 1 000 – experience: 250)	750
Claims expense	-600
Underwriting profit (CSM release: 400 – experience: 250)	150

Liability for remaining coverage (Debit)/Credit	FCF	CSM	Total
Opening balance	-400	400	0
Premiums received	750	-	750
Claims paid	-600	-	-600
Experience adjustment	250	-	250
CSM release	-	-400	-400
Closing balance	-	-	-

32

Example
Experience adjustments: Unexpected retention

» In current period insurer expects premiums of $1 000 from a group

» However, due to unexpected retention, it receives premiums of $1 750

» The unexpected retention obliges it to provide future services – the present value of that obligation is $550

» The insurer expected and paid claims of $600

» The insurer expected to release CSM of $400 in the period

» As a consequence of the experience adjustment, it now expects CSM release to increase by 100 in the period

Week 6, Question 2

33

33

Example
Experience adjustments: Unexpected retention

	Debit	Credit
Cash received	1 750	
Insurance liability		1 750
Insurance liability	750	
Insurance liability		550
CSM (applying B96(a))		200
Accounting for the experience adjustment		
CSM	500	
Claims expense	600	
Revenue (expected)		1 100
Accounting for CSM release and P&L presentation		

34

34

Example
Experience adjustments: Unexpected retention

Income statement (Debit)/Credit	2023
Revenue (Expected: 1 000 + experience: 100)	750
Claims expense	-600
Underwriting profit (CSM release: 400 + experience: 100)	150

Liability for remaining coverage (Debit)/Credit	FCF	CSM	Total
Opening balance	-400	400	0
Premiums received	1 750	-	1 750
Claims paid	-600	-	-600
Experience adjustment	-200	200	-
CSM release	-	-500	-500
Closing balance	550	100	-650

35

15

Example
Experience adjustments: Late payment

» In current period insurer expects premiums of $1 000 from a group

» However, due to late payments, it only receives premiums of $750

» The late payments are expected to be settled after year end

» The insurer expected and paid claims of $600

» The insurer expected to release CSM of $400 in the period

Week 6, Question 2

36

36

Example
Experience adjustments: Late payment

	Debit	Credit
Cash received	750	
Insurance liability		750
Insurance liability (cash to be received in future period)	250	
Insurance liability (cash not received in current period)		250
Note that B97 only forbids adjusting CSM		
CSM	400	
Claims expense	600	
Revenue (expected)		1 000
Accounting for CSM release and P&L presentation		

Week 6, Question 2

37

37

Example
Experience adjustments: Late payment

Income statement (Debit)/Credit	2023
Revenue (Expected: 1 000)	1 000
Claims expense	-600
Underwriting profit (CSM release: 400)	400

Liability for remaining coverage (Debit)/Credit	FCF	CSM	Total
Opening balance	-400	400	0
Premiums received	750	-	750
Claims paid	-600	-	-600
Experience adjustment	-	-	250
CSM release	-	-400	-400
Closing balance	-250	-	-

38

Coverage units

Could you please give <u>some recommendations for determining coverage units</u> for **annuities**, which contain both an investment and an insurance component (in particular, cases of immediate annuity and deferred annuity).

If the policyholder <u>can benefit from the investment component on its own</u>, then:

» Consider normal 'fee' and duration of accumulation component

» Consider normal margin and duration of annuity component

» Calculate expected CSM of both components and allocate proportionally

If the policyholder <u>cannot benefit </u>from the investment component on its own, then CSM is allocated only to the annuity component

Once pattern is established, apply consistently

Week 7, Question III.3

39

Example
Coverage units

» 5-year life annuity contracts, 5 with expected total profit of 50, 5 with expected total profit of 40, all contracts provide the same annuity per year

» Insurer expects that <u>all policyholders will survive,</u> discount rate is 5%

	Initial	Year 1	Year 2	Year 3	Year 4	Year 5
Remaining coverage units	50	50	40	30	20	10
Coverage units per year		10	10	10	10	10
Discounted coverage units		45.5	37.2	28.6	19.5	10
Unearned profit	90.0	94.5	77.4	59.4	40.6	20.8
Earned profit		20.8	20.8	20.8	20.8	20.8
		94.5 x (10/45.5)	77.4 x (10/37.2)	59.4 x (10/28.6)	40.6 x (10/19.5)	20.8 x (10/10)

10 contracts for 5 years
10 x 5 = 50

Week 7, Question

40

40

Example
Coverage units

» 5-year life annuity contracts, 5 with expected total profit of 50, 5 with expected total profit of 40, all contracts provide the same annuity per year

» Insurer expects that <u>one policyholder will die per year,</u> discount rate is 5%

	Initial	Year 1	Year 2	Year 3	Year 4	Year 5
Remaining coverage units	40	40	31	22	13	6
Coverage units per year		10	9	8	7	6
Discounted coverage units		36.8	28.2	20.1	12.7	6
Unearned profit	90.0	94.5	72.3	51.6	32.6	15.4
Earned profit		25.7	23.1	20.5	18.0	15.4
		94.5 x (10/36.8)	72.3 x (9/28.2)	51.6 x (8/20.1)	32.6 x (7/12.7)	15.4 x (6/6)

Week 7, Question III.3

41

41

Profit and loss presentation

Into what <u>components should the change in LIC be split</u> in P&L (for example, the effect of a change in discount rates, the effect of exchange rate differences)? What other components can be there?

The only required split is:

» Insurance service expenses (captures changes in claim amount and associated expenses expected to be paid), and

» Insurance finance expenses (captures changes in time value of money)

Depending on the terms of the contract, things like inflation and exchange differences may be service expenses or finance expenses

Week 7, Question III.4

42

42

Insurance law

43

Technical reserves

» Currently, reserves in Ukraine are formed in accordance with IFRS 4, national legislation (in particular the current law "On Insurance") and the terms of insurance contracts.

» The insurance contracts must provide for the guaranteed rate of investment return applied for the calculation of insurance tariffs.

» Under the new Ukrainian law "On Insurance" (current version, which comes into effect on January 1, 2024), insurers are obliged to form technical reserves, applying the rate of guaranteed profitability specified in the insurance contract.

» In addition, the policyholder's right to bonuses might be clearly indicated in the terms of the contracts. Moreover, insurance contracts may even provide for the principle of bonus calculation (the actually received investment income minus the costs of obtaining it and the sums sent to ensure the guaranteed return).

Week 7, Question I

44

44

Technical reserves
Differences in interest rates

When transferring to IFRS 17, several questions arise:

How to deal with the terms of contracts and the requirements of the law "On Insurance", which actually require the formation of technical reserves at a fixed discount rate of 4%? Will the liability for the remaining coverage, which according to IFRS 17 is formed by non-fixed discount rate curves, not be considered as a technical provision?

» IFRS 17 LRC is determined applying the discount rate curve

» The technical reserve is determined applying the discount rate of 4%

» The difference between the liability and the reserve is accounted for (net of tax) as a separate sub-component of the Insurers equity balance

Week 7, Question I.1

45

45

Example
Technical reserves

» Insurer opening retained income of $8 000, current period income of $4 000

IFRS and prudential liability/reserves	IFRS 17 LRC	Technical reserve	Difference
Year end 2021 balance	12 500	15 500	3 000
Year end 2022 balance	14 500	18 000	3 500

IFRS Financial statements (Debit)/credit	Retained income	Technical reserve	Total equity
Opening balance 2021	5 000	3 000	8 000
Profit and loss for the year	4 000	-	4 000
Transfer to technical reserve	-500	500	-
Closing balance	8 500	3 500	12 000

46

46

Example
Technical reserves

Prevailing practice in jurisdictions were similar occurs - either:

» IFRS 17 liability is reversed and replaced with full technical reserve, or

» IFRS 17 liability is

    » Retained and relabelled, but

    » If smaller then technical reserve, and additional reserve is created

    » Greater of approach

47

47

Technical reserves
Applying IFRS 17 reserving

Could in such case the following situation arise: the excess of investment income over the guaranteed 4% will have to be distributed under the contracts as bonuses, although in fact these funds are directed to increase the LRC (and cannot be used to provide additional coverage)?

» Applying IFRS 17, the insurer determines the expected future payments
   » Based on expectation, not on obligation
» If there is a guaranteed rate of 4%, and an expected bonus of 5%, then
   » IFRS 17 LRC will include expected cash flows of 9%
   » When paid, will decrease LRC

Week 7, Question I.2

48

48

Example
Probability weighted cash flows

» Two year policyholder investment of $10 000, policyholder earns 80% of interest rate, but guaranteed return of 4%

Scenarios	Nominal cash flow	Discounted cash flow	Implied CSM	Probability	Weighted cash flow
Interest rate of 2%	10 816	10 396	-396	5%	520
Interest rate of 4%	10 816	10 000	0	10%	1 000
Interest rate of 6%	10 983	9 775	225	45%	4 399
Interest rate of 8%	11 321	9 706	294	35%	3 397
Interest rate of 10%	11 665	9 641	359	5%	482
Weighted average cash flow			202		9 798

Week 7, Question I.2

49

49

Technical reserves

Currently, IFRS 17 has entered into force, but insurers in Ukraine continue to report in accordance with IFRS 4. In this case, how to build projected cash flows in under IFRS 17 in terms of future bonuses? Could you please advise either it should be done under the assumption that assets, which represent reserves, will be formed accordingly to IFRS 4 / IFRS 17 or on the condition that the insurer will be able to form reserves in compliance with IFRS 17 from a specific date in the future?

Assuming direct participation:

» Share of assets due to policyholders should be recorded as an IFRS 17 liability

» If not already reported as such under IFRS 4, will entail adjustment on transition

» Would recommend calculating amount because it will impact equity

Week 7, Question I.3

50

50

Transition

51

Transition

As of January 1, 2022, the insurance company has valid contracts concluded since 1998. On January 1, 2022, the company may perform a retrospective recalculation of contracts concluded in 2021, 2020 and, possibly, 2019.

As for contracts concluded earlier, starting from 1998, the company can only use the transition based on the fair value method.

To what extent, in your opinion, can such approach be appropriate, what assumptions can be used in this case, what disclosures should be performed?

Week 7, Question II.1

52

52

Example
Different generations

Groups of contracts issued:		
1998 - 2018	2019?	2020 - 2022

	1998 - 2018	2019?	2020 - 2022
Information required applying IAS 8			Fully retrospective
Reasonable/supportable information to apply modified approach		Modified retrospective	
Lack information to apply modified approach	Fair value		

Week 7, Question II.1

53

53

24

Transition disclosures

» If applying modified retrospective or fair value approach:
  » Explain methods used and disaggregated information
  » Provide separate reconciliations of CSM, eg:

Contractual service margin reconciliation		
Fully retrospective	Modified retrospective	Fair value
Existing contracts (unless impracticable) and new business	Existing contracts if retrospective application is impracticable	Existing contracts if retrospective application is impracticable

54

54

Transition
Discount rates

What approach to determining discount rates might be relevant?

If you are applying the fair value approach, then:

» Determination of the opening balance of the insurance liability is prospective, so **no discount rates required pre-2019**

» For post-2019, first determine what amendment you will apply to the observable curve looking forward (2023 onward)

» Then apply a similar adjustment looking back to 2020 to 2022

Week 7, Question II.1.1

55

55

Transition
Acquisition costs

What method of determining the amount of <u>unamortized acquisition costs</u> can you advise for contracts 1998-2019?

Applying the fair value approach:

» Determine the insurance acquisition cash flows the entity would incur at the transition date for the rights to obtain contract with the expected remaining cash flows

» Including for contracts not yet recognised, but

» Avoiding duplications with acquisition cash flows not yet paid

Week 7, Question II.1.2

56

56

Foreign currency

57

Foreign currency
Functional currency

If the functional currency (IAS 21) differs from currency of insurance contract how a company shall post exchange differences in accounting?

» A group of insurance contracts is a monetary item (IFRS 17.30)

» Therefore, applying IAS 21.21 - 24:
   » Group is initially measured in its contractual currency applying IFRS 17
   » Group is remeasured in its contractual currency applying IFRS 17
   » Carrying amount is converted each reporting period at closing rate to entity functional currency

» Treatment is consistent with other monetary items eg bank balances

Week 7, Question IV.2

58

58

Foreign currency
Functional currency

If insurance contract includes embedded FX derivative e.g. FX option how a company shall post exchange differences and present an amount of the embedded derivative in financial statements?

» Apply the separation requirements first (is the embedded derivative closely related)

» If it is, then accounted for applying the 'usual requirements of IFRS 17'
   » Accounted for as part of the present value of future cash flows
   » Depending on the nature, may be valued by reference to derivative pricing

» But see next discussion on multi currency

Week 7, Question IV.3

59

59

Foreign currency
Indexed contracts

How shall insurance company provide accounting of insurance contracts and make its presentation in financial statements <u>If insurance contract prescribes insurance premium payments indexation</u> by applying ratio of FX rate at payment date to FX at inception date?

» If all the cash flows of the contract are indexed to another currency, then that currency is the currency of the contract

» If some cash flows are indexed (eg premiums) and some are not (claims and other expenses) then the contract is in effect multi-currency

60

Foreign currency
Multi currency contracts

» An entity makes an accounting policy choice

» Single currency denomination:
  » changes in exchange rates are financial risk applying IFRS 17; and
  » changes in exchange rates between the selected group currency and the functional currency applying IAS 21

» Multi currency determination:
  » All changes in exchange rates are treated applying IAS 21

IFRIC agenda decision, October 2022

61

Direct participation contracts

Direct participation contracts

We also have a question on additional investment income under life insurance contracts (profit sharing). On one hand, profit sharing is part of future payments (outcome cash flow), i.e. it is accounted for accordingly to IFRS 17. However, on the other hand, received investment income is source of calculated profit sharing, accounted for in accordance with IFRS 9, so it is not part of income cash flow according to IFRS 17. This can lead to a negative CSM and the recognition of a loss component. Question: Should the group of contracts be defined as onerous in this case? Is additional reasoning for such cases required when preparing the reports?

» Typically these contracts apply the VFA model

» If so, the return on the assets is split between amount due to policyholder and CSM

Week 7, Question III.2

63

Example
Direct participation contracts

	Note, this captures extent that return will be shared with P/h	CU30 Changes reflect variable nature of fee
CU135 **Changes in fair value of underlying items (applying IFRS 9)**	CU105 **Changes in FCF** - liability for remaining coverage (including time value of money & financial risks)	(net of A and B) Captures how much remains for the benefit of the company

Dr Fair value assets
  Cr Profit or loss
	Dr Profit or loss
	  Cr FCF
		Dr Profit or loss
		  Cr CSM

Week 7, Question III.2

64

64

Variable fee approach

65

Question 2
Week 6

I understand that <u>VFA model is out of scope</u> of our Zoom-meetings – you told us about that. Even though so I would like to ask you <u>one general question about applying of VFA model in life insurance</u>. Therefore, could you please describe in <u>general an approach of applying VFA model in life insurance</u>? <u>When is VFA model used</u> to apply in life insurance practice?

Direct answer

» It will be used when life insurance contains qualifying investment element

» Examples, life contract with:

  » Claim amount linked to performance of underlying fund

  » Surrender value linked to performance of underlying fund

  » Values linked to performance of other contracts eg in a mutual

66

66

Core Requirements
Snapshot of IFRS 17 Approaches

Core requirements		
Insurance contracts with direct participation features	Reinsurance contracts held	Investment contracts with discretionary participation features

Modifications for contract Types

Simplifications: premium allocation approach
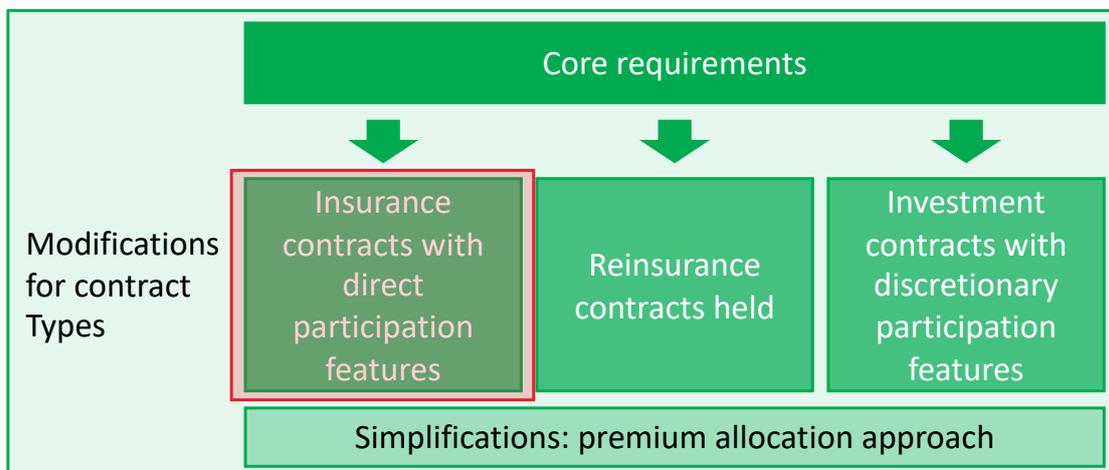
67

67

Contracts with participation features

68

What is a **participating** insurance contract?

Significant insurance risk

Issuer

Policyholder

Compensates on the occurrence of an insured event
AND some cash flows vary with underlying items
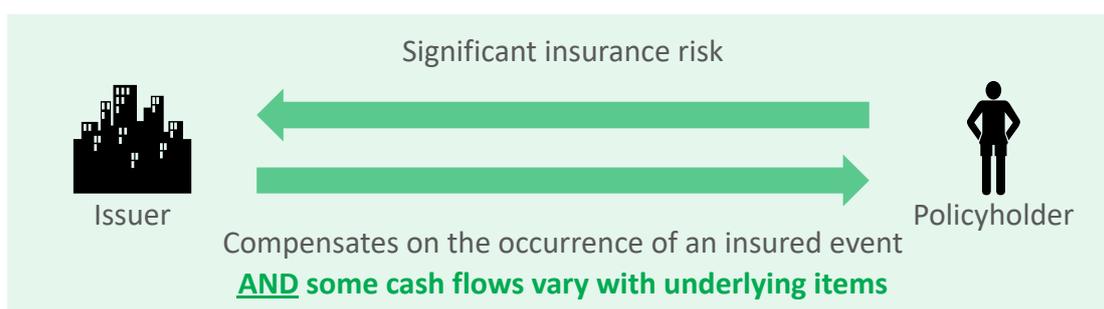
» Payments to policyholders vary with returns on underlying items through participation features

69

69

Participation contracts
Contracts with participation and other features

1 Insurance contracts **with participation features** may have **some or all of these** other features:

2 Financial options and guarantees

3 Discretionary cash flows

4 Cash flows that affect or are affected by other insurance contracts

Other features

70

70

Participation contracts
Extent of participation

» Insurance contracts:

No participation features
+
Indirect participation features → IFRS 17 core requirements

Direct participation features → Variable fee approach (VFA) Core plus modifications

71

71

Variable fee approach

82

Variable fee approach
When is the criteria applied?

Inception	Subsequently

Assess against VFA criteria*

Do not reassess after inception *unless* there is a specified modification

* considering all features of the contract eg whether the contract's cash flows affect or are affected by cash flows to other policyholders

84
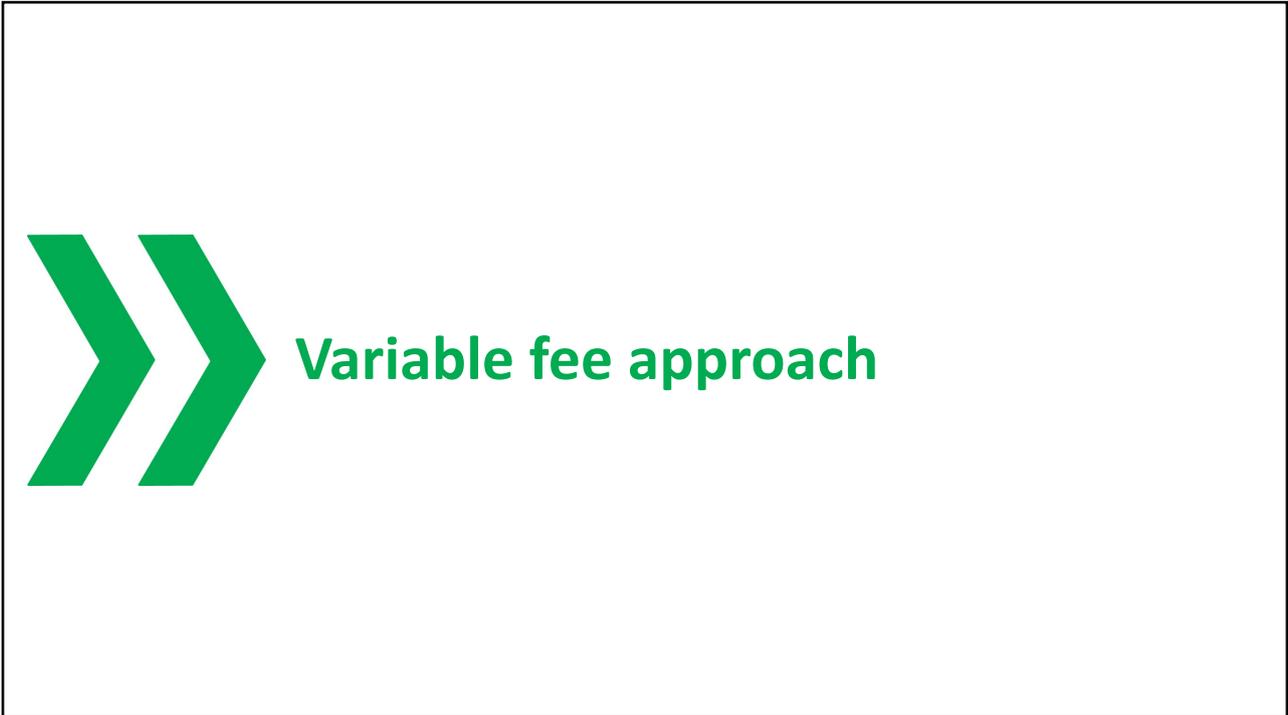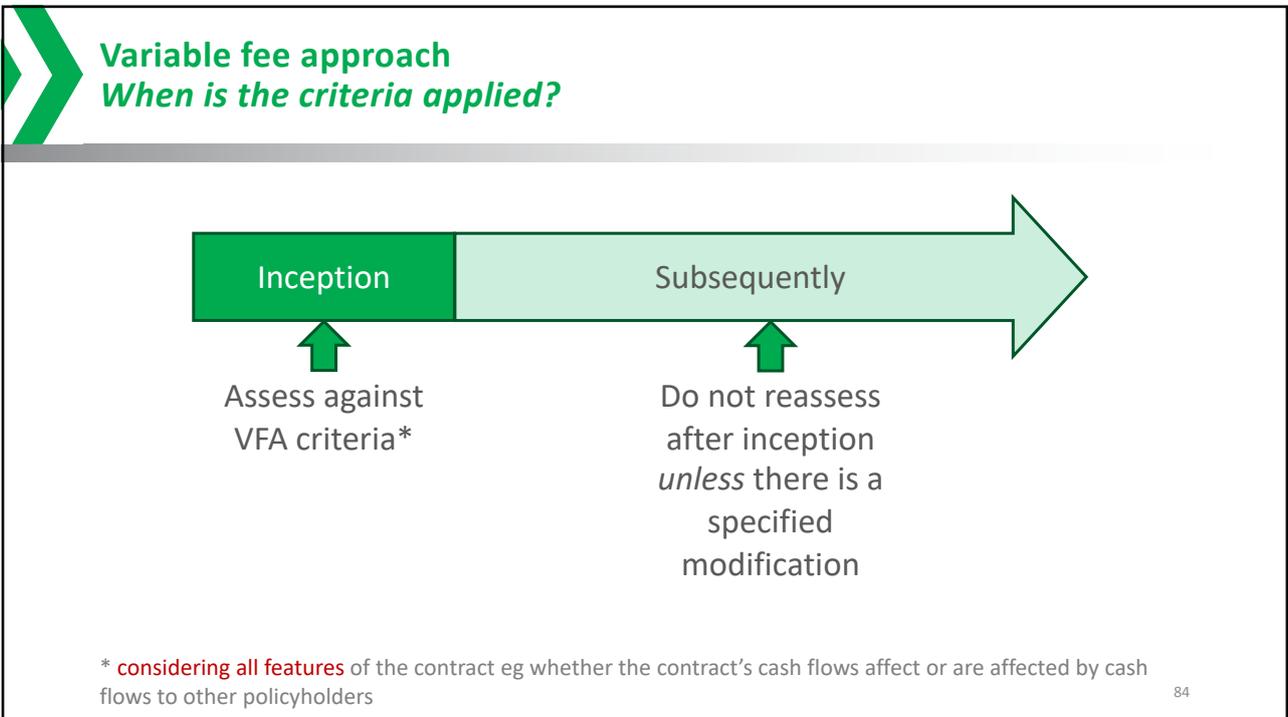
84

Variable fee
Criteria (a)

Contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items

» Discretionary cash flows do not preclude such a share

» Enforceable link to underlying items
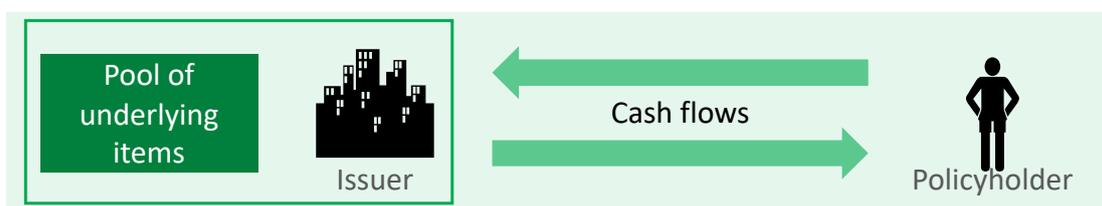
85

Variable fee
Criteria (a)
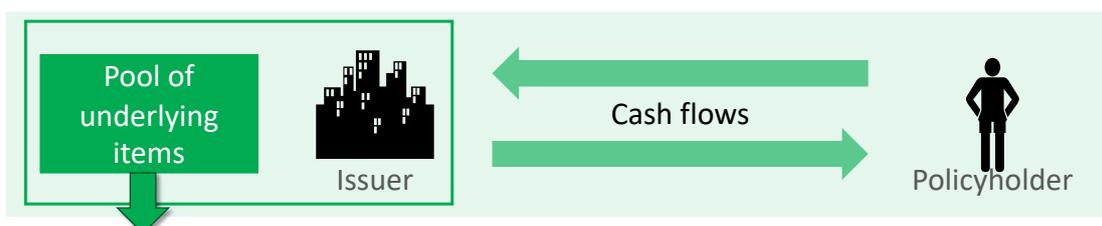
» Can comprise any items but must be identified in contract

  » eg net assets of the entity or a subset

» Need not be held - can be a reference portfolio of assets

  » eg index

86

86

35

Variable fee approach
Criterion (a)

Criterion a) **not** met if any of the following are applicable:

» The underlying items determining the amount of entity's obligation can be changed with retrospective effect

» No pool of underlying items is identified in the contract
    » eg past practice that policyholders receive a return that reflected the entity's (or a subset of assets) performance is not evidence by itself that there are underlying items identified in contract

87

87

Variable fee approach
Criterion (b) and (c)

The entity:

b) expects to pay an amount equal to a substantial share of the fair value returns on underlying items and

c) expects a substantial proportion of any change in the amounts to be paid to vary with the change in fair value of underlying items

Contracts with the following features are not precluded from meeting these criteria:

» a minimum guarantee return

» a return that is based on amortised cost of underlying items*

* Discussed at February 2018 IFRS 17 TRG meeting

88

88

Variable fee approach
Criterion (b) and (c)

For criteria b) and c):

» Interpret 'substantial' in the context of the objective:
  » provision of investment-related services and
  » a fee to compensate for that service determined by reference to underlying items
» Assess variability in amounts:
  » over the duration of insurance contracts
  » on a present value probability weighted average basis

If theoretically linked but no probability of exceeding guarantee then fails

89

89

Variable fee approach (VFA)
Relative to GMM

» Only difference is in subsequent measurement of CSM:

	Fulfilment cash flows		
	PV of future cash flows	Issue year Risk adjustment	CSM
Initial recognition	Same requirements	Same requirements	Same requirements
Subsequently	Same requirements	Same requirements	Different requirements

91

91

Variable fee
Day 1 obligations

Pool of underlying items

Issuer

Fair value of underlying
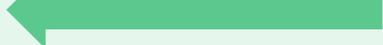
Variable fee
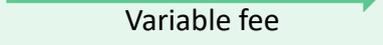
Policyholder

On Day 1, entity's obligation to policyholder (fulfilment cash flows) is equal to fair value of underlying items less a variable fee

The variable fee is deducted in exchange for future services to be provided and comprises:
» entity share of fair value of underlying items less
» changes in fulfilment cash flows not based on the returns on underlying items

92

92

Variable fee approach
Subsequent measurement of CSM

» Subsequently, the CSM is adjusted for changes in the variable fee:

Core

Changes in fulfilment cash flows related to future service applying core requirements

+

VFA Adjustments*

Changes in effect of time value of money and financial risk not relating to underlying items

+

Changes in entity's share of the fair value of underlying items

=

Changes in variable fee

Adjust the CSM to the extent that it does not fall below zero

Related to future service for contracts with direct participation features

* An entity could choose to recognise some or all of changes in effect of financial risk in profit or loss if specified risk mitigation conditions are met

94

94

Variable fee approach
Example

» Fact pattern – a group of insurance contracts with direct participation features

» Between initial recognition and the end of period 1:

» The fair value of the underlying items increases from CU1,000 to CU1,135. Change of CU135

» The fulfilment cash flows—liability for remaining coverage* are remeasured from CU795 to CU900. Change of CU105

* All fulfilment cash flows (both those that vary based on returns on underlying items and those that do not)

95

95

Variable fee approach
Simplified example

	Note, this captures extent that return will be shared with P/h	CU30 Changes reflect variable nature of fee
CU135 **Changes in fair value of underlying items**	CU105 **Changes in FCF** - liability for remaining coverage (including time value of money & financial risks)	(net of A and B) Captures how much remains for the benefit of the company
Dr Fair value assets Cr Profit or loss	Dr Profit or loss Cr FCF	Dr Profit or loss Cr CSM

96

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39
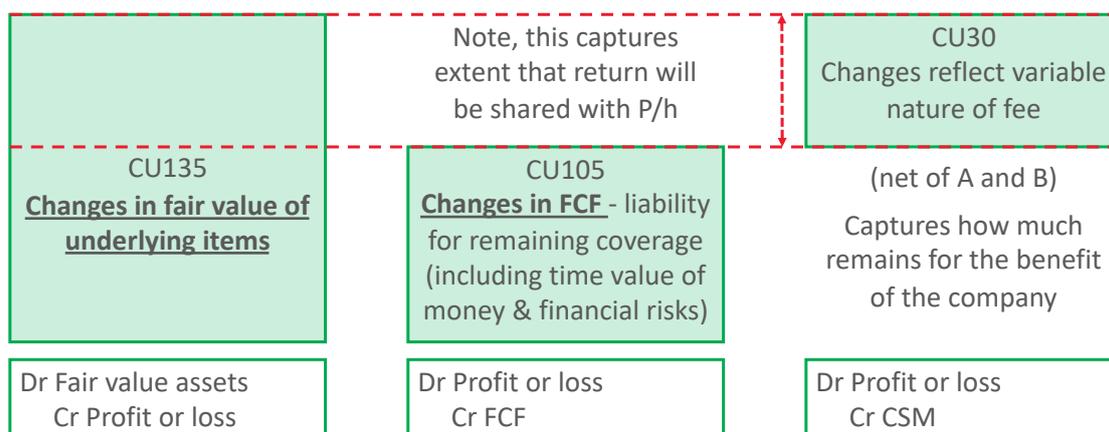
Variable fee approach
Simplified example

Journals	Debit	Credit
Asset return	135	
Fair value income		135
Return on assets actually held (which are also the underlying items)		
Fair value expense (underlying)	135	
Fulfilment cash flows		105
Contractual service margin		30
Allocation of fair value on underlying item to insurance liability		

97

97

③ Contractual Service Margin (CSM)
Subsequent measurement – core model

107

107

40