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## IFRS 17: 5 topics no-one knows the answer to

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23 November 2018

### Agenda

Current status

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VFA Eligibility

Dual CSMs

Expenses

Lifetime mortgages (LTMs)



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## IFRS 17: 5 topics no-one knows the answer to

### Current status

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### Current status

- The Transition Resources Group (TRG) has met three times in 2018. The next meeting has been delayed until 4 April 2019.
- The IASB tentatively agreed at its meeting in June 2018 to make a change to IFRS 17 clarifying that the coverage period of VFA contracts includes periods in which the entity provides investment services, and a number of minor changes.
- EFRAG has raised 6 key areas of concern in a formal letter to the IASB.
- CFO forum has also raised concerns (and proposals for solutions/work arounds).
- The IASB staff has identified 25 'concerns and implementation challenges' raised by stakeholders. At its October board meeting the IASB agreed a set of criteria that would be used to evaluate which, if any, of these items might be considered for making possible amendments to IFRS 17.
- A one year delay in the effective date of IFRS 17 to 1 January 2022 (and the effective date of IFRS 9 for insurers who have opted to defer the effective date of IFRS 9) was tentatively agreed by the IASB at its November board meeting.



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## IFRS 17: 5 topics no-one knows the answer to

### Coverage units

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### Coverage units

- Coverage units are determined by considering for each contract the quantity of the benefits provided and its expected coverage duration (IFRS 17.B119).
- The choice of coverage units can have a significant impact on the CSM release pattern and resulting revenue recognition – particularly for annuity business.
- The factors to be included in the measurement of coverage units are open to interpretation, including whether coverage units can be discounted.

#### Quantity of benefits

- The methodology used will require data at the contract level.
- There may be a trade-off in defining the 'quantity of benefits' between achieving an accurate measure of coverage provided and achieving a methodology that is operationally efficient.

#### Coverage duration

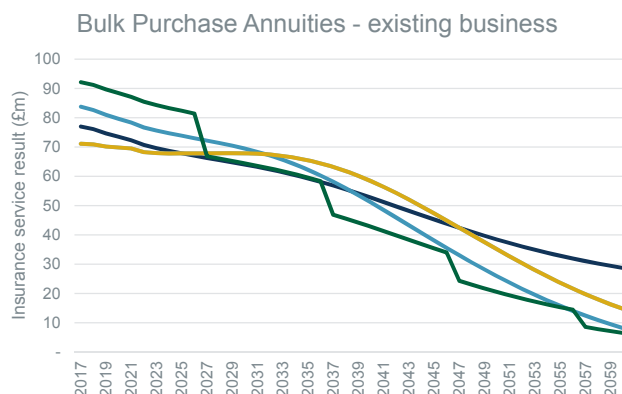
- The expected duration of contracts will be reflected by considering the number of contracts in the group and the expected coverage period of each contract in the group (IFRS 17.IE71 Example 6).



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## Example 2 – In-force: BPA (mix with c50% deferred)

- Below the Insurance Service Result based on a number of possible coverage units, for example policy count or annuity outgo, is shown. This is to highlight the impact different measures can have.



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## Coverage units

- If in a given period no insured event can occur then can any CSM be released? (IFRS 17.B119)
- When does the coverage period start for deferred annuity business and annuity contracts with a guaranteed period?
- If relating to insurance cover – how do you allow for additional cover (e.g. second life benefits)?
- If using a discounted coverage unit will it need to be discounted at the locked in rate?
- How should current period coverage units be calculated e.g. end of year, average of units over year?



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## Coverage units

The run off of the CSM should not be based on probability weighted cash flows but a separate calculation of the benefit amount and the expected duration. For a single policy this might have minimal impact, however, for a group of contracts and presentationally it will be different.

- ⚠ Example 1: expected death claims are X but actual deaths claims are zero. CSM should still be released as there **could** have been death claims (the insurer “is standing ready”)
- ⚠ Example 2: using PV AMCs as a choice of coverage unit. This is not in line with the IASB requirements, as if the asset manager changes the AMC charged, the PV AMCs would change but the service the insurer is providing does not.

Another area of concern is the distinction between insurance services and insurance risk combined with the clarification that General Model contracts only provide insurance services whereas VFA contracts provide both insurance and investment services.

- This could mean that for a non-profit deferred annuity there would be no CSM release prior to annuity payments starting.
- Similarly there could be no CSM release during any guarantee period



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## IFRS 17: 5 topics no-one knows the answer to

### VFA Eligibility

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## VFA Requirements

IFRS 17 defines different types of participation:

- Insurance contracts with direct participation features ("Direct Participating Contracts"). These are measured using a variation of the General Measurement Model.
- Investment contracts with discretionary participating features.

There are many types of contracts for which changes in financial risk have a substantial effect on the amounts paid to policyholders. Each jurisdiction will need to examine each type of contract to see if it meets the requirements to be a Direct Participating Contract. Some contracts may meet some but not all requirements in IFRS 17.B101.



Participating contracts that don't meet all of the requirements in IFRS 17.B101 are measured using the General Measurement Model



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## VFA Requirements

Direct Participating Contracts are defined as those contracts which meet a clear set of requirements set out in IFRS 17.B101. These requirements include:

- the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value of the underlying items (IFRS 17.B101(b))
- the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in the fair value of the underlying items (IFRS 17.B101(c))

In assessing whether a contract meets these requirement, consideration must be made of the impact of guarantees.

This means **there may be groups of insurance contracts within the same product which fail to meet the requirements for direct participation**, for example, where different levels of guarantees are chosen by different policyholders.

- Some contracts within a product grouping could be measured as Direct Participating Contracts while others are measured as insurance contracts without direct participation features.



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## VFA Requirements

There is uncertainty how the requirements in IFRS 18.B101(b) should be interpreted:

- Based on the way that fair value gains are actually allocated between shareholders and policyholders over the duration of the contract; and
- By comparing the expected return that will be earned in each period with the level of annual management charges that will be paid to the shareholders in the period

There is also some uncertainty how charges for insurance coverage should be included in this assessment.

## VFA Requirements

Both IFRS 17.B101(b) and (c) use the word “substantial”..



There is no clear consensus on this point. Views range from for example 80-85% is an appropriate level. Others feel this is arbitrary and are aligning with definitions of a majority shareholding/controlling interest in an asset i.e. 50%, or even lower.

Assessment of “substantial” is not made on a period by period basis but rather over the duration of the group of insurance contracts and on a present value probability-weighted average basis i.e. not a best or worst outcome basis



It is unlikely that a full stochastic assessment would be required, but what range of sensitivities is sufficient to ensure that the impact of any guaranteed minimum return is captured (IFRS 17.B108) and must the substantial criteria be met in all sensitivities?



## VFA Requirements

IFRS 17.B106 states that underlying items must be clearly identified by the contract. However, this could be a reference portfolio or the net assets of the entity. It does not need to be a separately defined fund belonging to the policyholder. The assets do not even need to be held by the entity (e.g. the underlying items could be a defined external index). Other insurance contracts (e.g. non-profit contracts in a with-profit fund) can also be underlying items.



Other insurance contracts will be measured at their fulfilment value for the purposes of presenting the contracts in the statement of financial performance but at fair value as underlying items for the purposes of measuring the direct participating contracts. This gives rise to a measurement mismatch.



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## IFRS 17: 5 topics no-one knows the answer to

### Dual CSMs

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## Dual CSMs

### What is a dual CSM?

For a group of entities that prepare IFRS financial statements, there are situations where the application of the requirements in IFRS 17 may lead to scenarios where different CSM calculations are required for:

1. the group consolidated financial statements; and
2. the individual financial statements of entities included in the consolidated financial statements.



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## Dual CSMs

### Situations where dual CSMs might arise?

	Group financial statements	Individual financial statements
Business combinations and portfolio transfers	Initial calculation of CSM is when the subsidiary or portfolio is acquired*	Initial calculation of CSM is when the contracts are issued (or acquired in a previous business combination or portfolio transfer)
Interim reporting	Separate CSM 'roll-forward' calculations for each six monthly period	One CSM 'roll-forward' calculation covering the entire year

\* Paragraphs B93-B95: In a portfolio transfer the consideration received is used as a proxy for the premiums received. In a business combination the consideration received is the fair value of the contracts acquired.



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## Dual CSMs

### Business combinations **under common control**

- If the transaction meets the definition of a business combination in IFRS 3 it is exempt from the requirements in paragraphs B93-B95 of IFRS 7
- The acquiring entity may elect to recognise the groups of contracts acquired at either:
  - Fair value; or
  - Book value (i.e. the value recognised by the acquiree)

### Portfolio transfers **under common control** (e.g. part VII transfers that are not business combinations)

- CSM at initial recognition is determined by using the consideration received as a proxy for the premiums received
- BUT, if the premium received is less than the lower of the fair value and book value or higher than the higher of the fair value and book value, the transaction might include a capital contribution or a distribution
- In these circumstances the premiums received might be determined to be either the fair value or the book value

Note: Part VII transfers might meet the definition of a business combination, or they might not. The IASB has recently issued an amendment to IFRS 3 narrowing the definition of a business combination effective in 2020



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## Dual CSMs

### Other considerations

1. If the fair value option is adopted at transition for a group of contracts both in the group and the subsidiary entities a group of contracts will have the same CSM at transition in the financial statements of both the group and the subsidiary entities.
2. Although the IASB staff did not identify the interim reporting issue as one that might meet the criteria for evaluating possible amendments to IFRS 17 in Board paper 2D discussed at the IASB's October board meeting it is conceivable that the IASB staff might reconsider its initial assessment.



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### Expenses

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### Expenses

Cash flows within the boundary of an insurance contract are those that relate **directly** to the **fulfilment of the contract**. The cash flows within the boundary include:

- An allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs [IFRS 17.B65(e)];
- Policy administration and maintenance costs [IFRS 17.B65(h)]; and
- An allocation of fixed and variable overheads **directly attributable to fulfilling insurance contracts**, such as the cost of accounting, human resources, information technology, building depreciation, rent and utilities [IFRS 17.B65(l)].

Cash flows relating to costs that cannot be directly attributed to the portfolio of insurance contracts that contain the contract, **such as** some product development and training costs should be excluded from the fulfilment cash flows. Such costs are recognised in profit or loss when incurred. (IFRS 17.B66).

What is meant by 'directly attributable to the fulfilment of the contract'?



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## Expenses

Fulfilment:

'The act or process of delivering a product (such as a publication) to a customer'  
(Merriam-Webster.com)

- Most current cost allocation systems fully allocate costs between acquisition; maintenance; and non-recurring costs (e.g. project costs).
- The costs of overhead functions (e.g. IT; HR; Finance and Actuarial) are allocated to each of these underlying activities.
- But these overhead functions undertake a number of activities that are not related directly to the act or process of delivering services to a customer (e.g. activities that would be necessary for an established business even if it had no customers, such as external reporting).
- **Most current cost allocation methodologies might not be appropriate, without adjustment, for the purposes of IFRS 17.**



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## Expenses

What are fulfilment expenses?

Investment expenses	
VFA contracts	✓
Non-direct participation contracts	?
Other general model contracts	✗
Other expenses	
Product development	✗
Training	✓ ✗
Other activities	✓ ✗

- VFA contracts are primarily investment-related services contracts
- Policyholders are credited with a return but the predominant service is not investment-related
- Benefits payable to policyholders are not investment-related.
- Cash flows **such as** some product development and training costs cannot be directly attributed to fulfilling insurance contracts
- Other activities?



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## Expenses

Statement of profit or loss	A	B
Insurance revenue includes:		
• CSM released in period	3	5
• Expected expenses	5	3
• Amortisation of insurance acquisition cash flows	8	8
	<b>16</b>	<b>16</b>
Insurance service expenses includes:		
• Incurred expenses	(5)	(3)
• Amortisation of insurance acquisition cash flows	(8)	(8)
Insurance service result	<b>3</b>	<b>5</b>
Other operating expenses		(2)
Profit before tax	<b>3</b>	<b>3</b>

### Example contract:

- Single premium contract
- Coverage period 5 years
- Premium 180
- Expected claims per year 20
- Acquisition costs 40
- Fulfilment expenses **(A)** 5 per year
- Fulfilment expenses **(B)** 3 per year
- Other expenses **(B)** 2 per year

- CSM released on straight-line basis
- Expected cash flows at inception are incurred as expected
- Time value of money and risk adjustment for non-financial risk are negligible



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## Expenses

Impact of excluding expected cash flows from fulfilment expenses (approach B):

CSM (services)	Other expenses	Profit impact: B v A
Level	Level	none
Front-end loaded	Level	Front-end loaded
Back-end loaded	Level	Back-end loaded
Level	Front-end loaded	Back-end loaded
Level	Back-end loaded	Front-end loaded

### BUT

- The CSM recognised at initial recognition would be higher
- The number of onerous contracts would be reduced at initial recognition and subsequently.



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Lifetime mortgages (LTMs)

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### Lifetime mortgages (or equity release mortgages)

#### Definition of an insurance contract:

- A contract that transfers significant insurance risk from the policyholder to the issuer of the contract.
- Insurance risk is significant, **if, and only if**, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (i.e. no discernible effect on the economics of the transaction).
- The condition in the previous sentence can be met even if the insured event is extremely unlikely, or even if the expected (i.e. probability-weighted) present value of the contingent cash flows is a small proportion of the expected present value of the remaining cash flows from the insurance contracts.

#### Are LTMs within the scope of IFRS 17?

- Is there a scenario with commercial substance where significant additional amounts could be paid on an insured event?



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## Lifetime mortgages

- The definition of an insurance contract has not changed from IFRS 4\*.
- IFRS 4 permitted 'grandfathering' of existing accounting policies. If there was no existing accounting policy for LTMs the general requirements in IAS 8 did not apply.
- If an entity did not have a previous accounting policy for LTMs fair value would have been an acceptable approach even if the contracts were insurance contracts within the scope of IFRS 4.
- Whether an LTM was within the scope of IFRS 4 or IAS 39 did not have a significant impact on the measurement or presentation approach adopted by insurers (either fair value, under IAS 39, or an insurance valuation model based on Solvency I, under IFRS 4).

### Measurement and presentation differences under IFRS 17 and IFRS 9 are more significant

- This is why the classification of LTMs under IFRS 17 has been coming under scrutiny.

\* Except for an additional requirement that a contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis.



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## Lifetime mortgages

### IFRS 17

General measurement model  
(comprising BEL+RA+CSM)

Level of aggregation requirements  
(including annual cohorts)

Insurance revenue model applies

OCI option

IFRS 17 presentation and disclosures

### IFRS 9

Fair value

Measured at the portfolio level

Deposit accounting

No OCI option

IFRS 7 disclosures

- Banks have been applying IFRS 9 since the beginning of the year.
- Most banks have classified LTMs as financial assets at FVTPL (because they do not pass the SPPI test). They have not classified LTMs as insurance contracts.



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## Lifetime mortgages

### If LTMs fall within the scope of IFRS 17

- Insurers will be required to measure LTMs on different bases for Solvency II and IFRS 17 (but they will be required to measure all insurance contracts on different basis for Solvency II and IFRS 17).
- The performance of LTMs and the annuities that they are held to 'back' would be more closely matched if the annuities are measured using the GMM (but not if they are measured using the VFA).
- Determining the discount rates for LTMs and the annuities that they back would introduce new considerations (if the annuities are measured under the GMM).
- Most banks would need to re-consider the measurement approach that they have adopted under IFRS 9.

In Board paper 2D discussed at the IASB's October board meeting the staff noted that it might be possible to amend IFRS 17 to exclude from its scope some or part of insurance contracts that have as their primary purpose the provision of loans or other forms of credit.



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## Questions

## Comments

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