IFRS 17 Locked-in assumptions

Introduction

The core aim of IFRS 17 is to provide more transparent information about the profit profile of insurance contracts. In particular, what level of profit is priced into contracts and when that profit is expected to be realised.

To facilitate this the IASB introduced the Contractual Service Margin (or 'CSM'). The CSM represents the amount of unearned profit priced into the contract. The CSM is set-up as a liability on the balance sheet and is reduced over time such that entities recognise profit in line with service provided.

The CSM represents the amount of unearned profit at the *outset* of the contract. As such, it is not adjusted to reflect changes in financial conditions over time. Article 274 of the Basis for Conclusions notes that "The contractual service margin does not represent future cash flows; it represents the unearned profit in the contract, measured at the point of initial recognition". It is believed that the IASB didn't want to distract readers of the accounts by reflecting the volatility of financial markets in the CSM. Instead financial assumptions are 'locked-in' and any volatility is reflected in the income statement.

What assumptions are locked-in to the calculation of the CSM?

IFRS 17.B97 states that an entity should not adjust the CSM (for contracts without direct participation features) for the following changes:

- Changes in the time value of money
- Changes in 'financial risks'

What is a financial risk?

Whilst the Standard makes it clear that the time value of money, should be locked-in from initial recognition it is less clear as to what it considers a financial risk and therefore what other assumptions are locked-in.

IFRS 17 Appendix A describes a financial risk as the 'risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index'.

IFRS 17 Article B128 goes on to consider the inflation assumption. It says 'assumptions about inflation based on an index of prices or rates' are financial risks. Where an assumption about inflation is based on 'the entity's expectation of specific price changes' this is not a financial risk.

Possible interpretation 1 - explicit contractual link

One way of interpreting this is where the contract includes an explicit link to a market observable index, then the variable is considered a financial risk and locked-in.

Let's consider an example. If you have an annuity contract where the benefit has an explicit, contractual link to CPI, under this interpretation, annuity benefit inflation would be locked-in.

In contrast, where the contract doesn't include an explicit, contractual link to an index but the entity *expects* the cost of a contract to increase in line with a given index, the assumption is not locked-in.

Let’s consider expense inflation as an example. Whilst expense inflation is likely to relate to the increase in cost of a number of things for simplicity let’s consider expense inflation in relation to salaries only. An entity may assume that salaries will increase in line with CPI, however unless there is a contractual link to CPI within employees’ contracts then this is the entity’s *expectation* of a specific price change and should not be locked-in.

Possible interpretation 2 - specific price changes

Another interpretation considers the key word to be ‘specific’ i.e. a variable is not considered to be a financial risk if it reflects ‘the entity’s expectation of *specific* price changes’. Under this interpretation expense inflation would be locked-in as it relates to the increase in the cost of a collection of things e.g salaries, rent, IT costs, third party costs etc.

In contrast, assumptions about specific price changes would not be locked-in. For example, if you have an insurance contract that includes specific health benefits, the expected increase in the costs of those treatments would not be locked-in e.g. the cost of dental care.

Conclusion

Whilst the Standard is clear that the time value of money should be locked-in from initial recognition, it is less clear what it means by ‘financial risk’ and therefore what other assumptions are locked-in. Insurers will need to set out a clear definition of a ‘financial risk’ variable and will need to assess whether each assumption meets this definition.

On behalf of the IFRS 17 CSM Working Party

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