

## Introduction to the Variable Fee Approach (VFA)

The VFA is an alternative measurement model to the General Measurement Model (GMM) for eligible products with direct participation features. Paragraph 45 and sections B101 to B118 of the Standards set out the VFA method. Within the UK, clear examples of applicable products would be Unitised and Conventional With-Profits business. Beyond the UK, Participating contracts within continental Europe and Asia would also likely be modelled within VFA. Some Unit Linked product lines also fall into scope for IFRS17; this is discussed further in section 1 below.

VFA introduces the concept of a “Variable Fee”, which is loosely defined as the entity’s share of the underlying items as a fee for the services it provides. The main benefit of applying VFA would be to better manage the volatility of the entity’s balance sheet.

The key difference between the VFA and the GMM is only evident at subsequent measurement, the transitional and at inception CSM is the same under both models. This difference is the ability to bring economic movements into the CSM each period as compared to the P&L under the GMM. This reflects the fact that future profitability is significantly impacted by market movements via either AMCs or asset shares. Without this mechanism, the insurance service result for these products would not reflect the reality, and the net investment result would be incredibly volatile.

Whilst the definitions above sound sensible and clear, there are some grey areas where judgement may be required:

1. Should the produce be measured using IFRS 17 or IFRS 9<sup>1</sup>?

This is especially pertinent for Unit Linked Savings products. Where a UL product has insurance features (such as guaranteed minimum death benefits or where the option of waiver of premium has been selected), it will be valued under IFRS 17, otherwise it will be valued under IFRS 9.

Particular care is needed for products which allow investment in both UL and UWP funds. Investment in Unconventional With-Profits (UWP) funds brings the product in scope of IFRS 17.

Some Unit Linked Pension products may also end up within IFRS 17 by virtue of policy options. Under IFRS 17, if benefits on the contract are highly inter-related or inter-linked with the underlying contract, they cannot be unbundled and the cash flows are measured on a whole contract basis. For example, a pension policy (IFRS 9) has waiver of premium (IFRS 17), then we have to measure the cash flows for the pension and the waiver together under IFRS 17.

2. Is the product eligible for the VFA within IFRS 17?

To be eligible for the VFA, the product must have “direct participation” features. This works well for Unit Linked and traditional with profits business but doesn’t work well where there are hybrid contracts, such as unitised products with a significant protection component. If the components can be unbundled then the participating component will be valued under VFA with the protection component under GMM. But how does this align to the way the business is managed? How do you avoid future profit distortions?

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<sup>1</sup> IFRS 9 is the new accounting standard for investment business which comes into effect alongside IFRS 17 on 1/1/22

### 3. What about reinsurance?

Currently, reinsurance does not meet the criteria to be considered under VFA as there is no participation within the reinsurance contract. Even if the underlying business is measured under VFA, the relevant reinsurance assets must be measured under GMM. This will create an accounting mismatch, especially in respect of market movements. Will this change the industry's appetite for reinsurance?

The working party will be investigating these issues and more over the coming months. Please do join in the debate with your thoughts, opinions or questions by commenting on the Linked in article

On behalf of the IFoA IFRS 17 CSM Working Party

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