Submission date	20/07/2018

Potential implementation question

During the May 2018 TRG meeting there was extensive discussion on Agenda Paper 5 on *determining quantity of benefits for identifying coverage units (AP5).*

We would like to seek further clarification on this topic, specifically on the determination of the quantity of benefits for identifying coverage units for contracts described in IFRS 17:B75 that have cash flows that vary based on the returns on underlying items.

Based on the current wording of IFRS 17, the calculation of the coverage units appears to ignore the investment-related services provided by the contracts described in IFRS 17:B75. To this effect, in the May TRG meeting, the IASB staff stated that they plan to recommend to the Board a narrow amendment to IFRS 17 to modify the definition of **coverage period** for variable fee approach (VFA) contracts to clarify that it includes the period in which investment-related services are provided.

The amendment proposed by the IASB staff would appear to address the challenge for the insurance contracts described in IFRS 17:B75 only when they meet the criteria for VFA.

Pending the IASB decision on the proposed IFRS 17 amendment we seek guidance on how to determine the quantity of benefits for calculating the coverage units for the contracts described in IFRS 17:B75.

Background

IFRS 17:B75 states that *"Paragraph B74(b) requires cash flows that vary based on the returns on underlying items to be discounted using rates that reflect that variability, or to be adjusted for the effect of that variability and discounted at a rate that reflects the adjustment made. The variability is a relevant factor regardless of whether it arises because of* ***contractual terms*** *or because the* ***entity exercises discretion****, and regardless of whether the entity holds the underlying items."*

The contracts described by Paragraph B75 have cash flows that vary based on the returns on underlying items would be measured using the **variable fee approach (VFA),** if they meet the criteria described in Paragraph B101 of IFRS 17 or the **modified General Measurement Model (GMM),** if they fail the VFA criteria.

Both type of contracts measured under VFA and modified GMM offer insurance services and investment-related services to produce the effect of cash flow variability that the policyholder seeks from purchasing these type of insurance contracts.

To illustrate the issue described above, we will provide two examples based on products sold in the Chinese market including Hong Kong.

Example 1: Universal Life

Fact pattern

- This contract is a long term universal life insurance plan, providing life insurance protection and account value accumulation
- It offers flexibility in premium payment and level of death benefit
- It is funded through a single premium or annual premiums, with the possibility of additional unscheduled premiums

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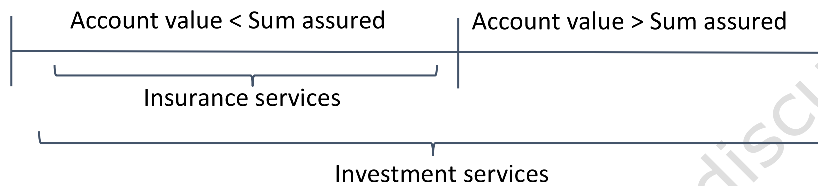
- It is a whole of life policy
- After deduction of a premium charge, the premium is allocated to an account value
- The account value accumulates with a crediting rate. The crediting rate varies based on the yield of the underlying assets, subject to a minimum guaranteed rate.
- Mortality and expense charges are deducted from the account value.
- On death, the policyholder receives the maximum of the fixed and guaranteed sum assured or the account value.
- On surrender, the policyholder receives the account value net of surrender charges.
- Depending on the investment returns and claims experience, the account value may be projected to exceed the sum assured over the lifetime of the policy. However, there is also a risk that the investment returns are insufficient to cover the cost of insurance and expense charges, in which case the account value falls to zero and the policy lapses automatically.

The diagram below demonstrates the services offered by the Insurer



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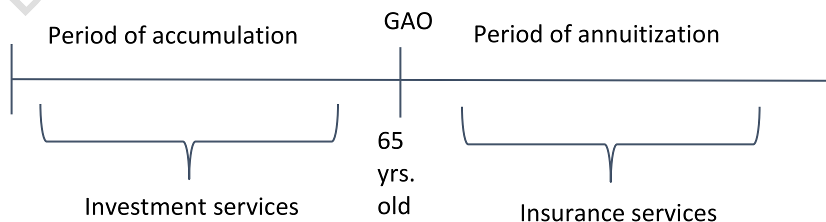
Example 2: Deferred annuity

Fact pattern

- This contract consists of regular premium payments paid up to when the customer is 65 years old
- It has a guaranteed annuitization option that can be exercised at age 65
- After deduction of a premium charge, the premium is allocated to an account value
- The account value accumulates with a crediting rate. The crediting rate varies based on the yield of the underlying assets, subject to a minimum guaranteed rate.
- Expense charges are deducted from the account value.
- On death prior to reaching the age of 65 years old, the policyholder receives the account value.
- On surrender, the policyholder receives the account value net of surrender charges. No surrender is possible when the annuitisation is elected
- The insurer's stand ready obligation to pay fixed and guaranteed annuity amounts for as long as the customer lives starts from when the customers reaches the age of 65 years old

The diagram below demonstrates the services offered by the Insurer



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Application of IFRS 17

IFRS17:B119 states that "An amount of the contractual service margin (CSM) for a group of insurance contracts is recognised in profit or loss in each period to reflect the **services** provided under the group of insurance contracts in that period. The amount is determined by: *(a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the* ***quantity of the benefits*** *provided under a contract and its* ***expected coverage duration****".*

IFRS 17: Appendix A defines coverage period as "*The period during which the entity provides coverage for* ***insured events****. This period includes the coverage that relates to all premiums within the boundary of the insurance contract".*

Analysis of the question

We will provide an analysis of two scenarios for each product described in the background section; in the first scenario the product does not qualify for VFA and in the second scenario the product qualifies for VFA accounting treatment.

Example 1: Universal life

A simplified approach has been used to model the CSM amortization for this product under the GMM and VFA approaches.

First scenario – Product does not qualify for VFA

View A:

- The quantity of benefit is defined as the sum payable in the event of an insured event occurring less any investment component that exists at that date. This represents the insurance component payable in the event of a claim (often this amount is referred to as "net amount at risk"), while the account value is treated as the investment component under IFRS 17. The investment component is non-distinct and it is accounted for under IFRS 17 rather than IFRS 9 via unbundling;
- The insurance coverage period ends when the account value exceeds the sum assured, and insurance services are no longer provided according to the current IFRS 17 definition

View B:

- The quantity of benefit is defined as the sum assured and the coverage period is the expected duration of the contract. This is because the unbundling of investment and insurance components is not required under IFRS 17 for this contract. The investment component is only identified when incurred claims are recognized (BC34). Even when the investment component is larger than the sum assured the insurance component payment would be part of the cash flows representing the insurance benefit.
- The insurance coverage period covers the entire term of the contract, as the sum assured is payable in the event of death over this period even when the investment component is larger than the sum assured and no additional benefits are payable compared to payments made in all other scenarios.

Second scenario – Product qualifies for VFA

View A and View B would be identical to the first scenario

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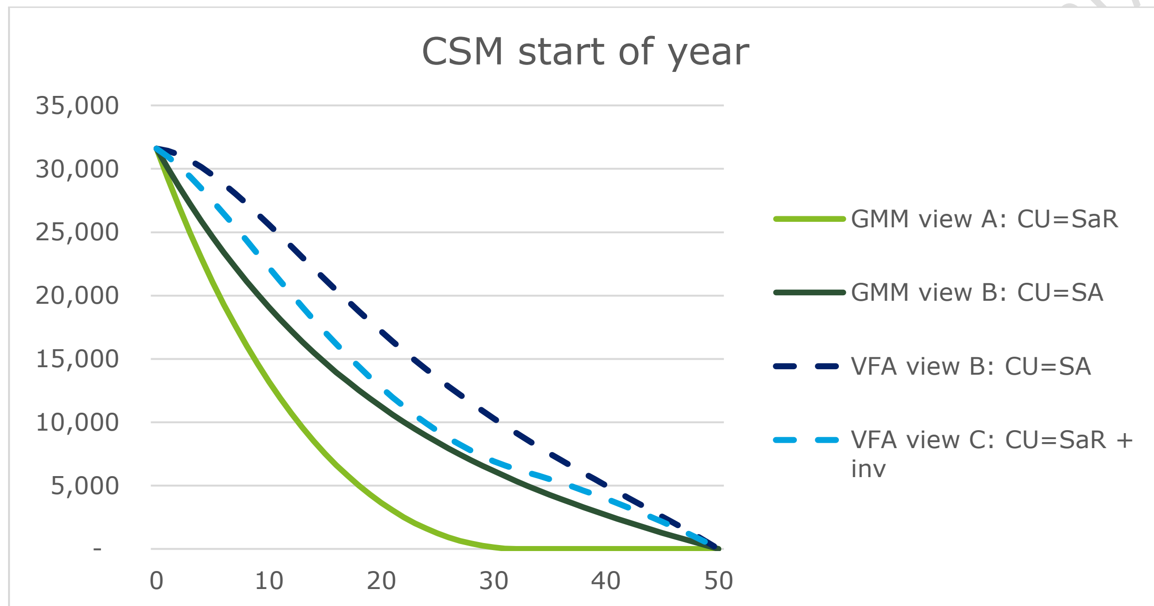
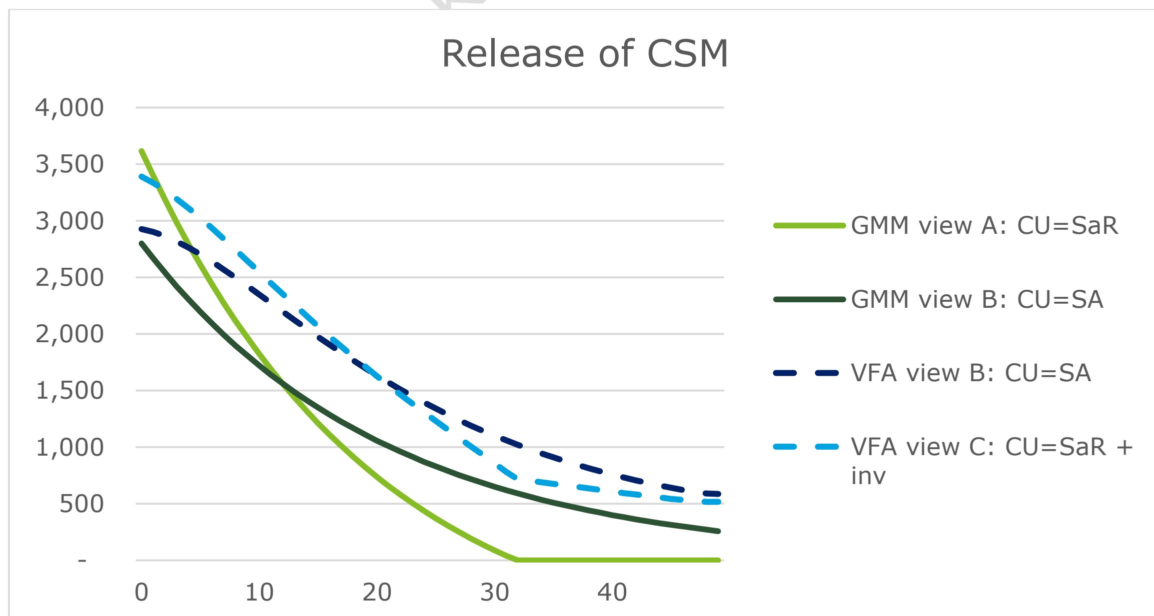
View C (assuming the proposed IASB staff amendment to IFRS 17 is adopted)

- The quantity of benefit considers both the insurance service and investment-related service. In this example, the coverage unit is derived as: net amount at risk + inception account value. The net amount at risk represents the insurance component. The inception account value represents the investment component, and we assume that the investment service is level over the period, in line with the treatment it would receive under IFRS 15.
- The coverage period covers the entire term of the contract (taking both insurance and investment service into account).

Illustrations





Example 2: Deferred annuity contracts

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First scenario – Product does not qualify for VFA

View A:

- The quantity of benefits is defined as the annuity payment
- The insurer will stand ready to pay for life fixed and guaranteed payments based on a guaranteed annuitization included in the contract at the point of sale
- The quantity of benefits is constant over all future periods during which the insurer stands ready to pay annuity amounts. The total number of coverage units would be subject to any changes from the unlocking of the expected coverage period
- During the accumulation stage (between 0-65years) the insurer does not have to stand ready to pay annuity amounts and there is no insurance service since the coverage period starts upon retirement (age 65)
- The total coverage units is updated based on the changes of the expected coverage period but no units are allocated to reduce the CSM and recognize insurance revenue before annuitization date

View B:

- The insurance risk is guaranteed from initial recognition date therefore the insurer is providing the benefit of a guaranteed annuitization option at this time. The stand ready obligation is effective from that date albeit with a deferral to be fulfilled from the annuitisation date onward
- The quantity of benefits is defined as the guaranteed annuity payments for life, increasing in line with the premium payments over the accumulation period. The coverage period starts from the beginning of the contract when the price for the stand ready obligation is determined and guaranteed
- The coverage period covers the entire term of the contract and only considers the insurance service. The insurer will therefore be earning CSM from the beginning of the contract assuming the constant quantity of benefits is allocated to each period from initial recognition (scaled in line with premium payments)

Second scenario – Product qualifies for VFA

View A and View B would be identical to the first scenario

View C (assuming the proposed IASB staff amendment to IFRS 17 is adopted):

Based on the proposed amendments to IFRS 17:

- The quantity of benefit and coverage period consider both the insurance service and investment-related service
- During the accumulation phase, the quantity of benefits and consequently the coverage units will be determined by taking into consideration the investment related service
- The quantity of benefits during this phase is expected to be variable and could depend on the regular premium payments in the policyholder account
- The quantity of benefits during the annuitization phase (from retirement until death) and consequently the coverage units will be constant given that the payments are now fixed and guaranteed for life
- The coverage period covers the entire term of the contract and considers both insurance and investment related service into account. The insurer will therefore be earning CSM from the beginning of the contract

Illustrations

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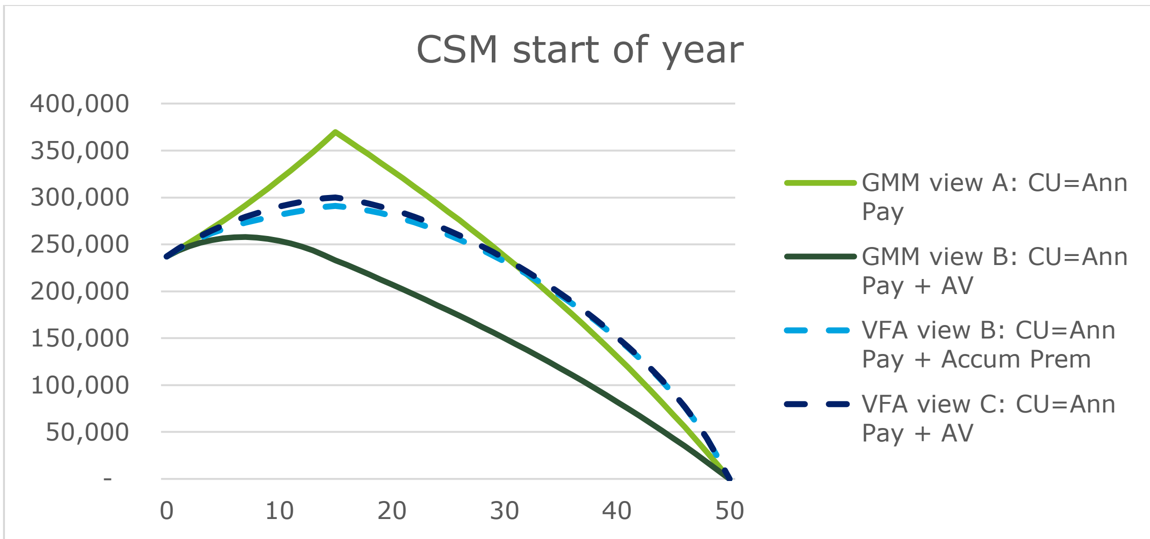

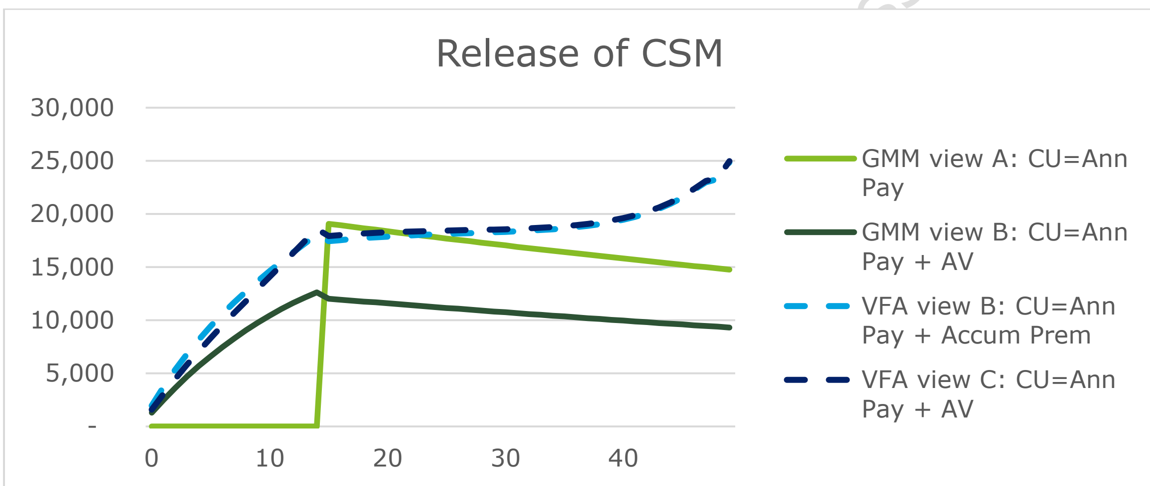

Conclusion

The amendment proposed by the IASB staff would address the challenge for the insurance contracts described in IFRS 17:B75 that meet the criteria for VFA accounting. However, the accounting for other contracts such as those described in IFRS 17:B75 that do not meet the VFA criteria the interpretation of IFRS 17 remains unclear and the possibly of materially different revenue and profit from insurance contracts that present economically similar characteristics to those that meet the VFA criteria remains in place.

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