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IFRS 17: The Variable Fee Approach

Basics and Challenges

June 2023

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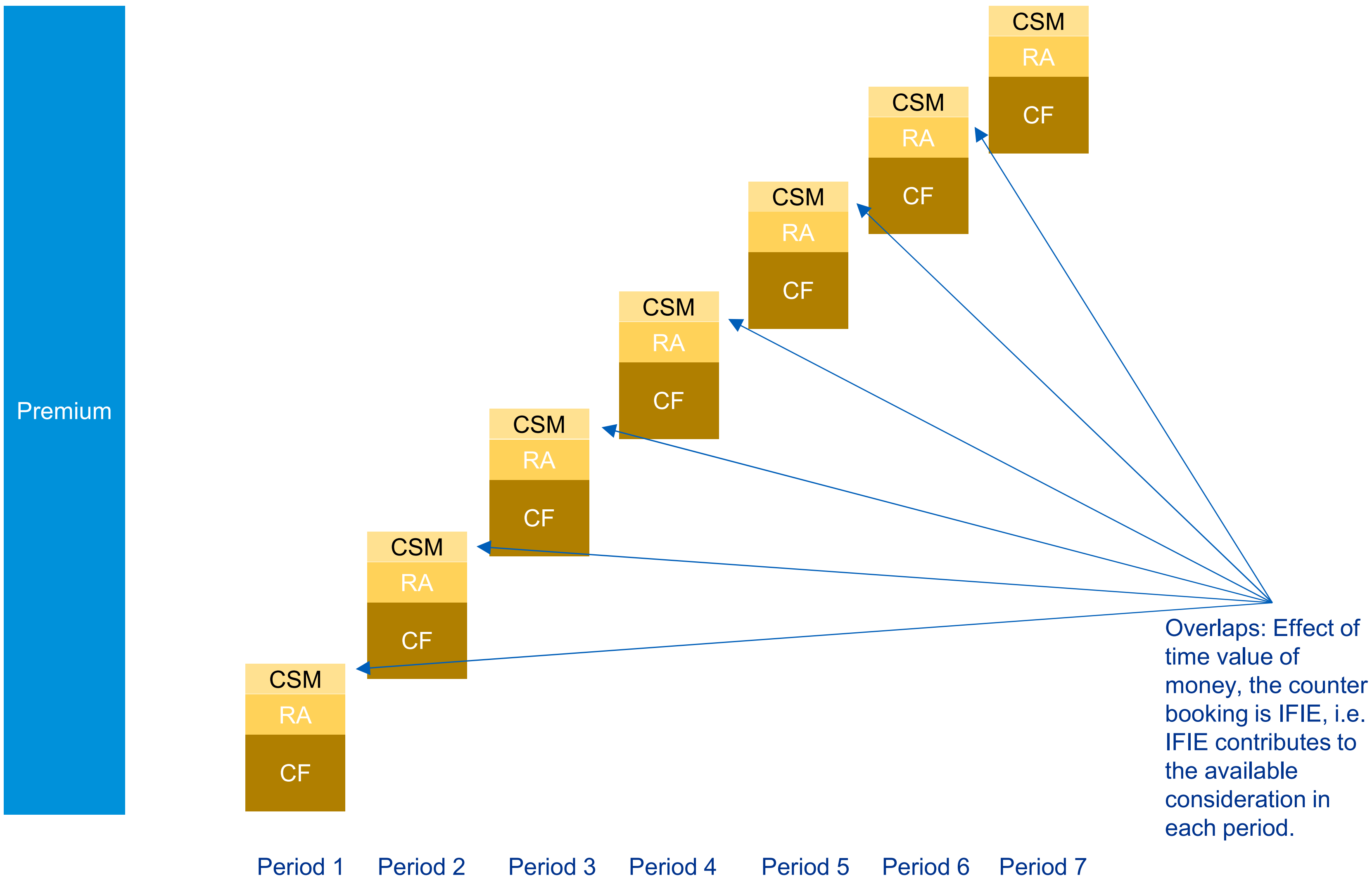
The Concept of Revenue Recognition

The background of revenue recognition of the GM

- The parties negotiate a **price for the service**.
  - The expected profit margin at outset (after deducting **opportunity cost**) is disclosed in the notes (initial CSM of the contract before adding the contract to the GIC and separately the additional opportunity cost).
- The price, **plus the time value of money** earned on it in the meantime, is allocated to periods where services are provided.
  - The allocation is actuarially regarding the risk-adjusted expected present value of cash flows directly related to the fulfilment (FCF). These are the **objectively determinable parts** of the demanded consideration.
  - Regarding the remaining CSM, i.e. the part of the premium, which is **not objectively determinable**, why it was charged, it is based on an **accounting convention** to allocate the margin in proportion to the volume of insurance contract services provided (the convention is the restriction to those services and the definition of volume of service).
    - Note: The differences between accounting systems for insurance contracts are based on how to estimate the objectively determinable part and the accounting convention how to allocate the remaining part of the premium.

Allocation of premium to periods

Example: The entity provides for 7 periods the same service.



The background of revenue recognition of the GM

- The increase of future considerations for services in periods due to time value of money is presented immediately as insurance finance expense.
- The change and release of prices not related to services, i.e. effects to cash flows of and risk adjustments for financial risk (bearing of financial risk is not a service), is immediately presented as insurance finance income or expense.

The background of revenue recognition of the GM

- The allocation to periods is **revised prospectively** if circumstances change. The movement between FCF and CSM is just a **change in the allocation pattern** to periods and accordingly results in a different allocation of the same total amount, the premium plus time value of money, to the periods.
- If the objectively determinable parts of the premium, the FCF, change, it is assumed that this is **compensated by the not objectively determinable part, the CSM**.
  - This assumption was made by the IASB in 2013. Before, the IASB assumed that each part of the premium is measured separately, i.e. any change in the FCF had been presented immediately in P&L as gain or loss.

The background of revenue recognition of the GM

- The part of the price for services allocated to the period (as of the end of the prior period) is recognized as **insurance revenue**, i.e. as the consideration received for the services to be provided in the period.
- The consideration is compared in P&L (insurance service result) with the actually incurred expenses for providing services in the period (**insurance service expense**).
  - The insurance service expenses are split in the notes between those related to services in the period and changes in the LIC, i.e. related to unsettled services of past periods.
  - The profit from the provision of services in the current period is the difference between insurance revenue and the insurance service expense related to current services.

The background of revenue recognition of the GM

- Insurance revenue is the consideration received for the service in the period as negotiated in the past, its initial margin represents the **performance of selling** by the entity, as higher the price as higher is the potential profit, as lower as lower is the potential profit.
- Insurance service expense represents the expenses actually incurred in performing the obligation, i.e. the **performance of providing the service** in the period, as lower, as higher the profit, as higher as lower the profit.
- Both together make up the **performance of the entity** from providing services.

Sources of entity's performance in providing services

The background of revenue recognition of the GM

- Regarding **financial risk**, the allocation is based on locked-in assumptions as at outset, i.e. the changes in price components resulting from financial risk are not allocated to periods in relation to services but **immediately presented in P&L** (or OCI).
- Bearing financial risk is not seen in accounting as part of the services and therefore **no allocation incurs**. Changes relate to that period where they incur.
- The idea is that the entity is assumed to **match time value of money and financial risk at outset 100%**, although this is in practice impossible. Changes in the fair value of the matching "assets" are assumed to be presented immediately in IFIE and accordingly as well the corresponding change in the FCF is presented immediately in IFIE.
- The result of any **deviating actual investment of premiums is fully at the risk and ownership of the insurer**. This is not part of the measurement under IFRS 17. As a matter of principle, **IFRS 17 does not consider at all how the entity might invest the premiums** (sole exemption: OCI-split in case of VFA contracts where the entity holds the u/is).
  - That has severe consequences particularly for the determination of the discount rate, which must not consider that it is impossible to invest fully illiquid, e.g. therefore SII, which intends to be realistic in that regard, applies a liquid rate, which is not permitted under IFRS 17, here the discount rate has to reflect the (deterministic) character of the amounts to be discounted, the risk-adjusted expected value of the period cash flows.

The peculiarities of direct participating contracts

- Direct par contracts include a contractual (!) **reference to a pool of underlying items** (u/is) and it is assumed in measurement that premiums are invested in those u/is and that the u/is determine broadly the overall obligation, not as in non-par contracts where the investments are made to broadly matching the (mostly fixed) cash flows. However, the measurement under IFRS 17 does not care how the insurer is actually invested, neither for GM nor VFA.
- Further, the returns generated by those u/is belong contractually and in addition effectively in such an extent to the policyholder that any **remaining share of the insurer cannot be seen as an ownership share** but is seen as part of the fee charged contractually for the entire services of the contract.
  - Background is, that the difference between the returns generated by the u/is and the amounts to be paid to the p/h is not simply owned by the insurer – the **contract refers directly to the returns on the u/is** rather than independently determining the amounts to be paid to the p/h – and it is **the contract which determines, which amount belongs (at least) to the p/h and which amount belongs to the insurer**, i.e. the **insurer's amount is contractually determined, i.e. a fee**.

The peculiarities of direct participating contracts

- Both features together result in the fact that as well any effect of time value of money and financial risk from the contract (including u/is) to insurer's profit is seen as part of the fee, the remuneration for current and future services and therefore any change is allocated to all remaining services by adjusting the CSM.
- The result from the u/is is not seen as being in the first instance owned by the entity.

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The basic concept: IFRS 17.B104

IFRS 17.B104

The conditions in paragraph B101 **ensure** that insurance contracts with direct participation features are contracts under which the **entity's obligation to the policyholder** is the net of:

(a) the obligation to pay the policyholder an amount equal to the fair value of the underlying items; and

(b) a **variable fee** (see paragraphs B110–B118) that the entity will deduct from (a) in exchange for the future service provided by the insurance contract, comprising:

(i) the **amount of the entity's share of the fair value of the underlying items**; less

(ii) **fulfilment cash flows that do not vary based on the returns on underlying items**.

What is the meaning of IFRS 17.B104?

- IFRS 17.B104 is fundamental for the understanding of insurance contracts with direct participation features.
- It is assumed ("ensure") that any contract meeting the criteria in IFRS 17.B101(a)-(c) (as repeated from IFRS 17.A) has the characteristics described in IFRS 17.B104.
- IFRS 17.B104 does therefore not establish criteria itself but describes consequences of IFRS 17.B101(a)-(c).
- IFRS 17.B104 introduces terminology for subsequent measurement paragraphs.
- **The key statement of IFRS 17.B104 is that in case of a VFA-contract (i.e. meeting IFRS 17.B101), the amount in IFRS 17.B104(b) is a "fee", not an ownership element. (See AP 2A March 2015 para. 23-29, IFRS 17.BC241/BC243.)**
- If it is not a "fee", the VFA does not apply. IFRS 17.B101(a)-(c) defines the situation where it seen to be a "fee".

IFRS 17.B104

In formula:

Changes do not adjust the CSM

IFRS 17.B111

Changes adjust the CSM

IFRS 17.B112

Changes adjust the CSM, except releases

IFRS 17.B113

entity's obligation to the policyholder = obligation to pay the policyholder an amount equal to the fair value of the underlying items − [amount of the entity's share of the fair value of the underlying items − fulfilment cash flows that do not vary based on the returns on underlying items]

= Total FCF

= IFRS 17 value of u/is

IFRS 17.B101

This must be a **Variable Fee** not ownership interest !

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entity's obligation to the policyholder − fulfilment cash flows that do not vary based on the returns on underlying items = obligation to pay the policyholder an amount equal to the fair value of the underlying items − amount of the entity's share of the fair value of the underlying items

= Total FCF

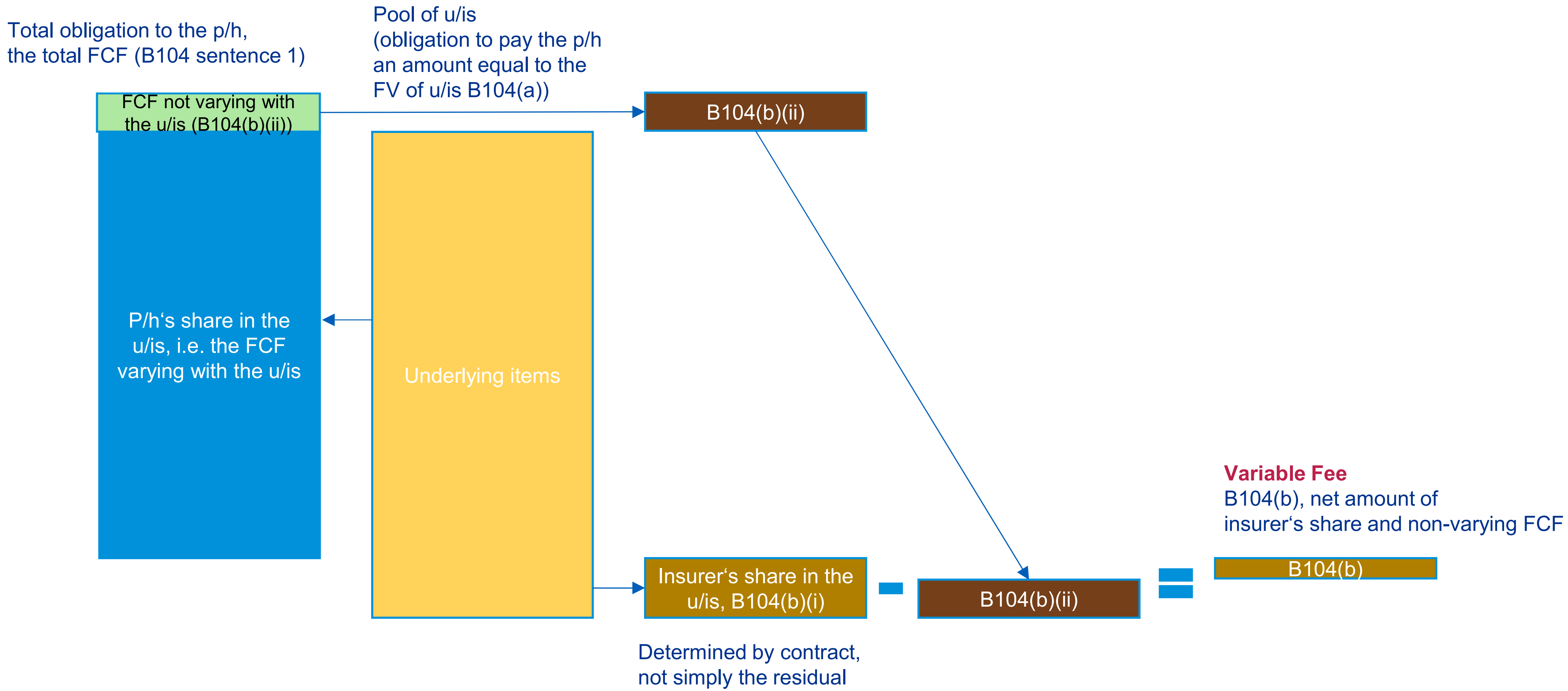
= IFRS 17 value of u/is

Applying logic: =

fulfilment cash flows that vary based on the returns on underlying items

FCF that vary based on the returns on underlying items are those FCF, whose payment fulfils the obligation to pay the policyholder an amount equal to the fair value of the u/is and are not entity's share.

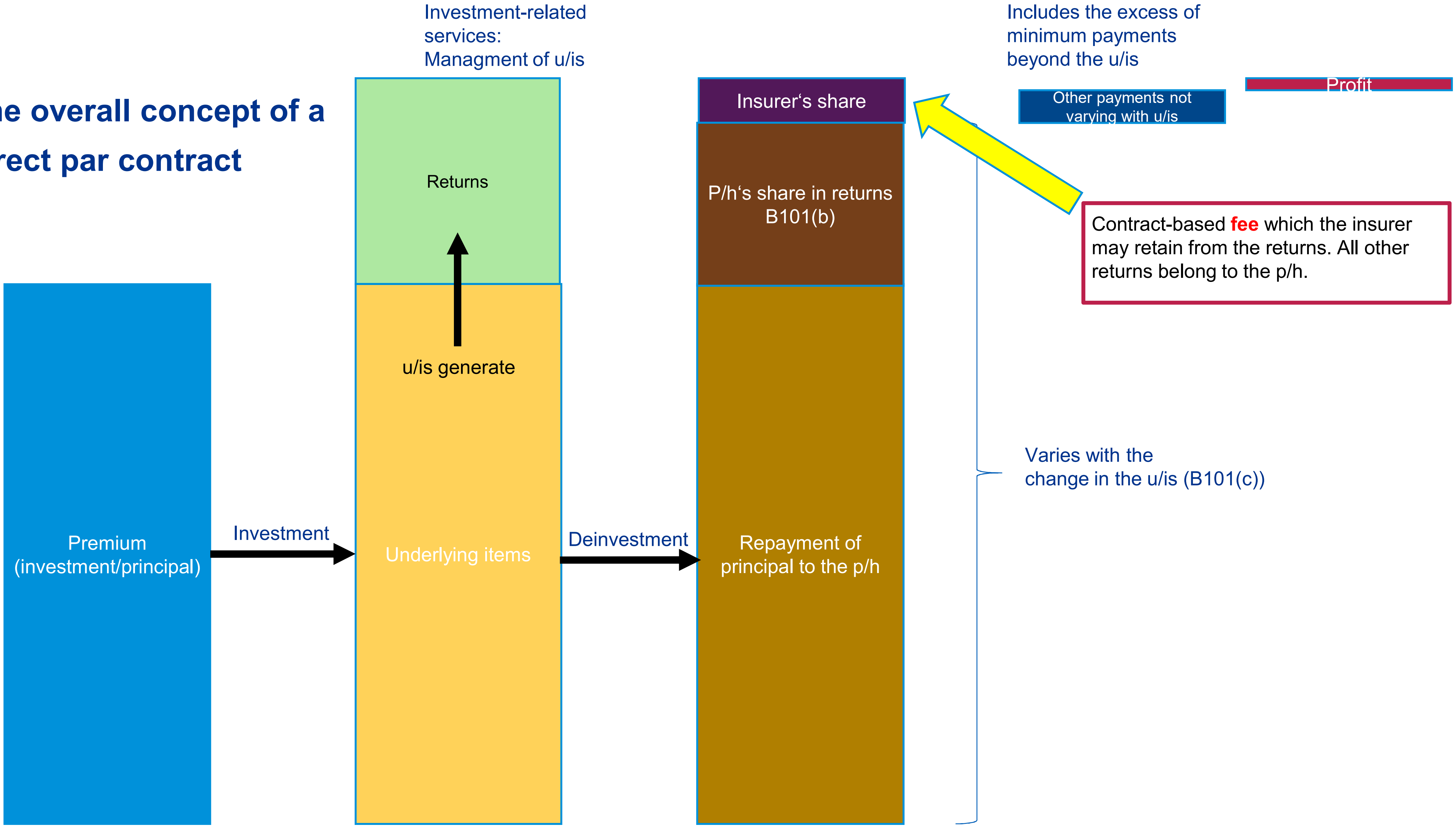
IFRS 17.B104: Another perspective



The fair value of the u/is generated by the premiums and the returns thereon represent the obligation to the p/h plus any non-varying payment minus the insurer's share.

IFRS 17.B104 (AP 2A March 2015 para. 15, IFRS 17.BC242(a)/(b))

The overall concept of a direct par contract



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Conclusion

- The entire premium paid (the principal) is translated to the u/is.
- The return on the u/is is the sum of any subsequent change of value of the individual u/is.
- Any movement of the amount of the u/is can be differentiated between
  - change in the value of one given u/i
  - adding one item, which was before not contractually included in the pool of u/is, to the pool, i.e. it is from now on representing an obligation to the p/h
  - deducting one item, which was before contractually included in the pool of u/is, from the pool with the consequence that the item does no longer represent an obligation to the p/h.

What is a fee and why is its accounting different?

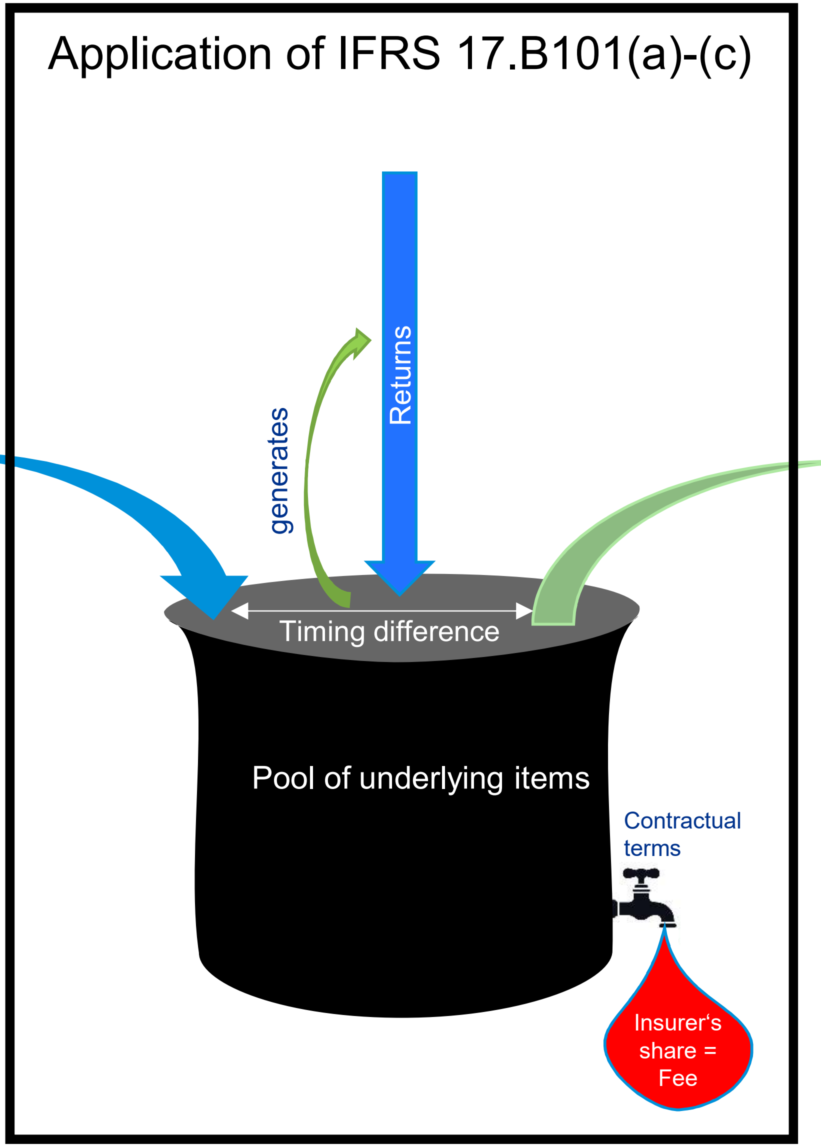
- The key feature of direct participating contracts is that insurer's share in the (all) returns on (all) underlying items has not the nature of an ownership right but is merely a **contractually determined fee** charged for the provision of services.
  - In case of an ownership right, the returns are recognized in P&L when incurred.
  - In case of a fee, the fee is recognized in P&L when the related service is provided, i.e. it might be deferred or anticipated compared with the date where it is received by the entity.
- An ownership right is given, if the entity bears in substance all risks from an asset or a liability. If in substance the risks are born by another party and the entity just receives a minor, contractually specified share for providing associated services, it is a fee, even if the fee varies with the performance.

Concept of VFA

Key feature of VFA-contracts is the relationship of the insurer to the pool of underlying items. The contractual terms operate the valve, i.e. the profit and contribution to cost of providing the investment-related services is a contractually determined fee which may be variable, but the amount and variability must be so insubstantial that it cannot count as an ownerschip relationship.

The absolute volume of the pool or its proportional size to the volume of premiums and benefits at any time, determined by the length of the timing difference, is not relevant for meeting the criteria in IFRS 17.B101(a)-(c). Relevant are only the relations between the volume of the pool, the returns and the insurer‘s share.

Premiums



Benefits provided to p/h (or other p/hs on behalf of the p/h):

- Cash benefits
- Transferred assets
    - Financial assets
    - Increase of rights to receive services or payments*
- Off-setting premiums for future services or payments or other obligations of the p/h*

*) Can include market-adequate profit and compensation of cost

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Terminology: Underlying items, returns, varying, inheritance, mutualisation, etc.

What are underlying items?

- Underlying items are “**Items that determine some of the amounts payable to a policyholder**.”
- To do so, they need to have a nature which enables them to serve as **index**, i.e. they are **numerical** with a starting amount and an end amount and they are **observable and definite**. But there is no explicit restriction beyond those natural features.
- Underlying items are not exclusive for direct participating contracts. Items, which influence the amounts to be paid can **exist as well for GM-contracts** (compare IFRS 17.120, B65(c), B67, B74(b) …).
- Outside VFA, the linkage between an underlying item and the cash flow does **not need to be contractual**, theoretically it can be as well factual or due to the behavior of a party, however, it needs to be demonstrable based on reasonable and supportable information.
- To make sense, insured events should not be seen as underlying items determining the compensation. Generally, underlying items would not be indices specific for one of the parties (i.e. its changes represent financial risk), but can be.

What are underlying items?

- Underlying items in case of direct participating contracts need to have specific features, at least for the “defining” underlying items, i.e. the underlying items to which the criteria in IFRS 17.B101 apply.
  - In theory, there could be as well cash flows varying with underlying items other than the defining ones (e.g. an inflation-indexed death benefit). It should be assumed that the references to underlying items in the specific guidance for direct participating contracts refer to “the” underlying items, i.e. the defining ones.
  - The key feature of underlying items in case of direct participating contracts are:
    - They are contractually **clearly identified**.
    - They are an **index in which the premium is conceptually invested**, i.e. the index is calibrated to the amount of the premium, and the subsequent development determines substantially the obligation to the p/h.

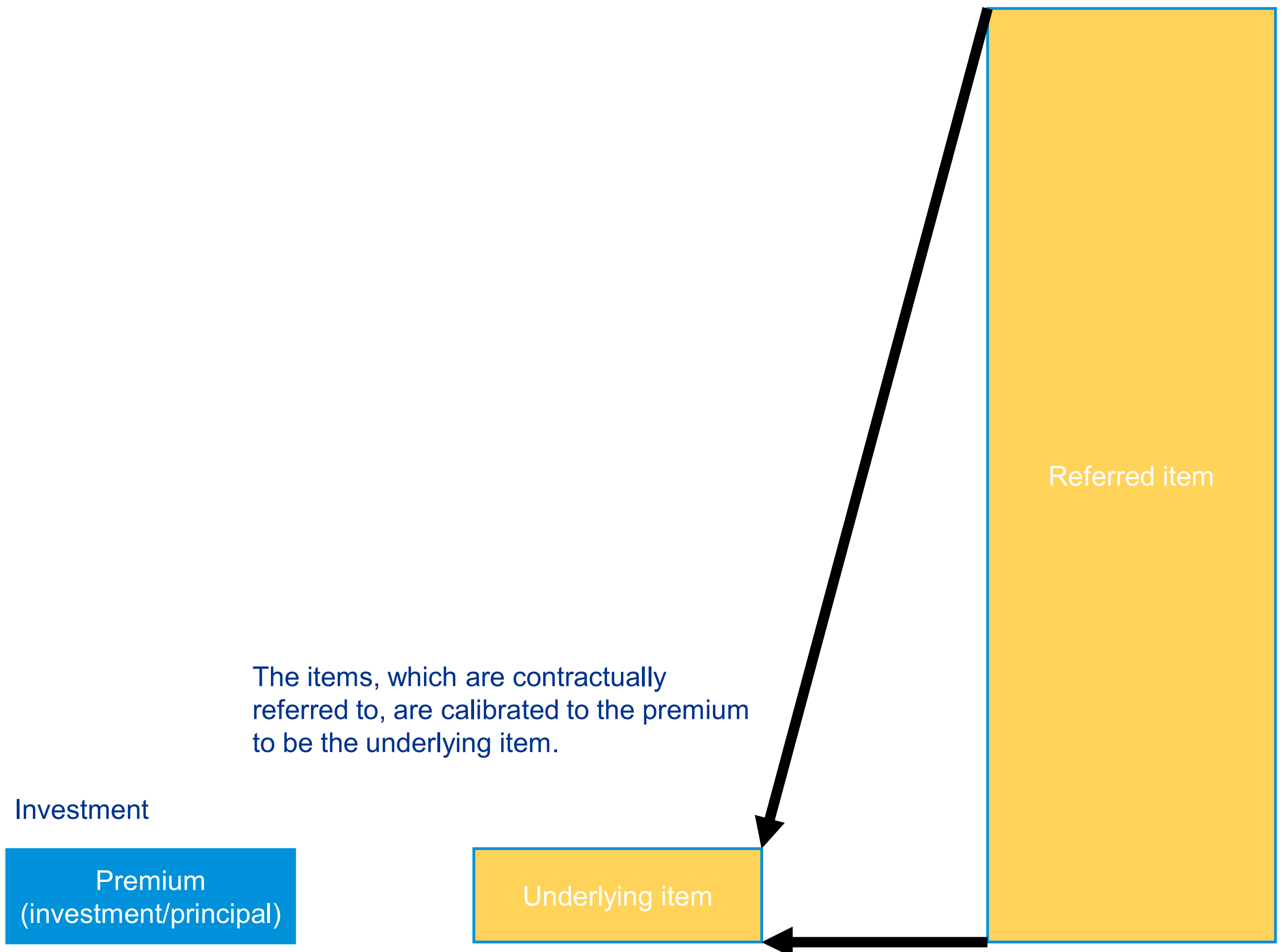
What are underlying items?

- Contractually clearly identified means that the source of the effects to the cash flows can be **derived from the contract**.
  - It is not necessary that the contract explicitly mentions the underlying items.
  - If the contract e.g. determines that the investment returns of the entity determine the cash flows, it is clear that the investments hold by the entity are the underlying items. The reference to the returns of all investments identifies all investments as underlying items.

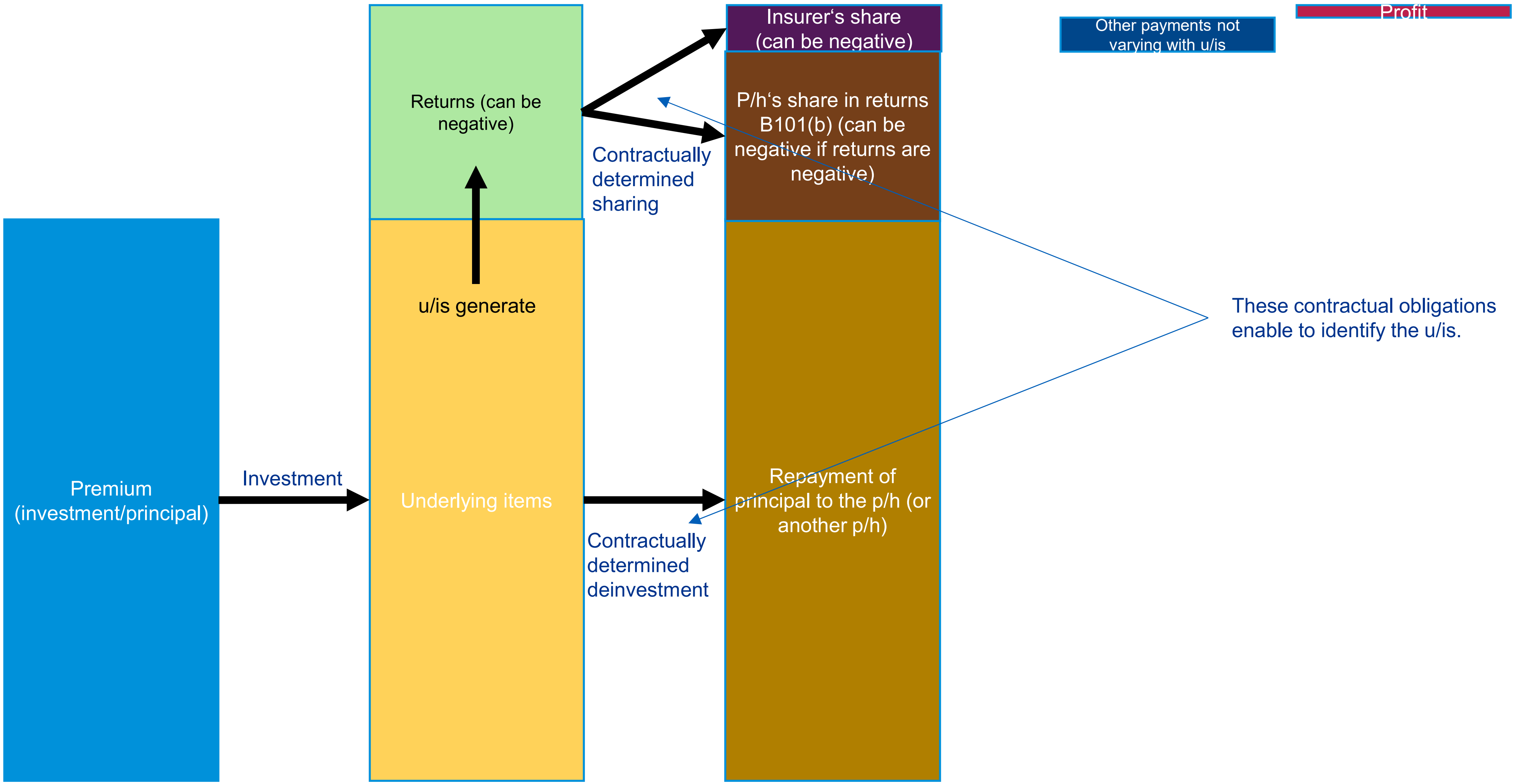
What are underlying items?

- The idea is that the obligation to the p/h is indexed with the development of the underlying items.
- For that purpose, it is first necessary to calibrate the underlying items to the amount of the premiums: The initial obligation equals the premium and therefore, since as well the initial underlying items represent the obligation at that time, the underlying items need to equal initially the premiums. Any consumption of the premium after payment is a withdrawal of the insurer from the underlying items, i.e. already part of the insurer’s share.
- E.g., if the amount of the premiums is 100, at that time the amount of the respective items is 1,000, the calibration is 1:10, i.e. the underlying item is 1/10 of the amount of the respective item.
- If at the end the amount of the respective items is 2,000, applying 1:10 results in an obligation of 200.
- Often, the initial underlying items are assets acquired with the premium, i.e. have directly the correct amount.

Identification of underlying items (u/is)



Identification of underlying items (u/is)



What are underlying items?

- Example: Germany
  - The premium payment received increases the bank account of the insurer.
  - Since the gains and losses from the bank account is part of the surplus source “interest”, the currency units of the premium in the bank account are the initial underlying items of the contract.
  - Anything subsequently is only an exchange of underlying items at fair value, a transfer of returns in additional underlying items, a consumption or a withdrawal of underlying items.
  - Effectively, the premium is invested in the total pool of investments of the entity, i.e. the same percentage of each investment is allocated to the contract in the total amount of the premium. The items of the total pool are calibrated to the contract to determine its u/is.

What are underlying items?

- U/is are contractually identified features, not accounting features. It is a matter of fact, as identified in the contract, whether an item determines a contractual cash flow or not, i.e. whether it is at that time an u/i.
  - If the contract identifies that from today onwards an item determines the contractual cash flows, the item is from today onwards an u/i.
  - If the contract identifies that from today onwards an u/i does no longer determine the contractual cash flows, the item if from today onwards no longer an u/i.
- As a consequence, accounting amounts might not be consistent with the pool of u/is:
  - E.g. CSM might be partially covered by u/is, equity might be partially covered by u/is. It is an accounting issue when an amount is moved from CSM to equity, the contractual identification of u/is might have a different timing.

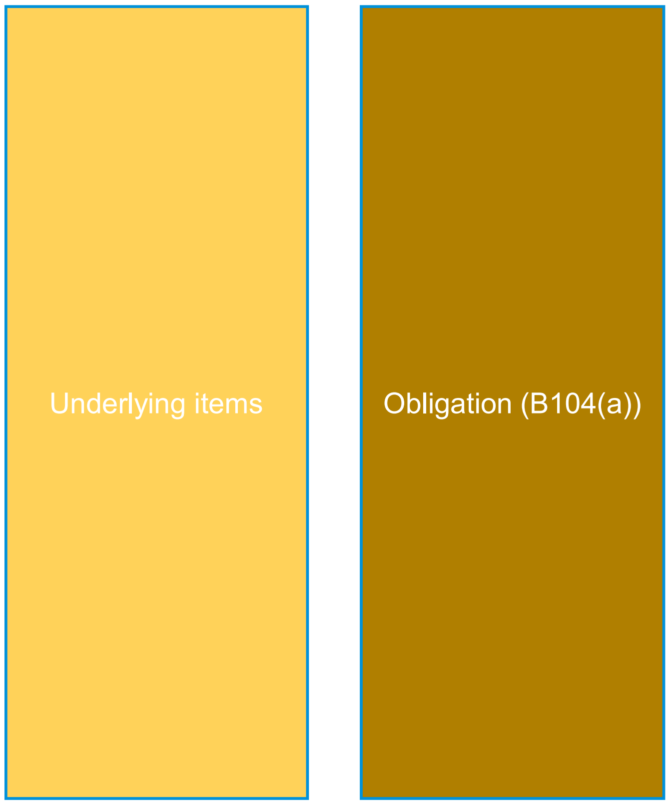
What are additions, withdrawals and changes of u/is?

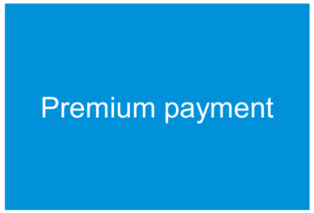
- IFRS 17.B128(c) refers to “changes in the value of underlying items (excluding additions and withdrawals)”
- Additions and withdrawals are contractual changes in the composition of the u/is, i.e. a physical movement of u/is, as identified by the contract. That is reflected by an increase or decrease of the obligation.
- Other changes of the value of u/is are changes where the change in value of single of u/is results in a change of the value of the pool of u/is of unchanged composition which triggers the change of the obligation.
- Changes in the composition of the pool of the u/is by exchanging prior u/is at fair value with other items moved to the pool do not change the fair value of the pool of the u/is.

Changes in the value of u/is: Addition

Most common case: Premium payment and accumulation of investment returns received, but as well insurer‘s subsidies (negative share) or payments by the reinsurer,may cause additions.

Prior situation

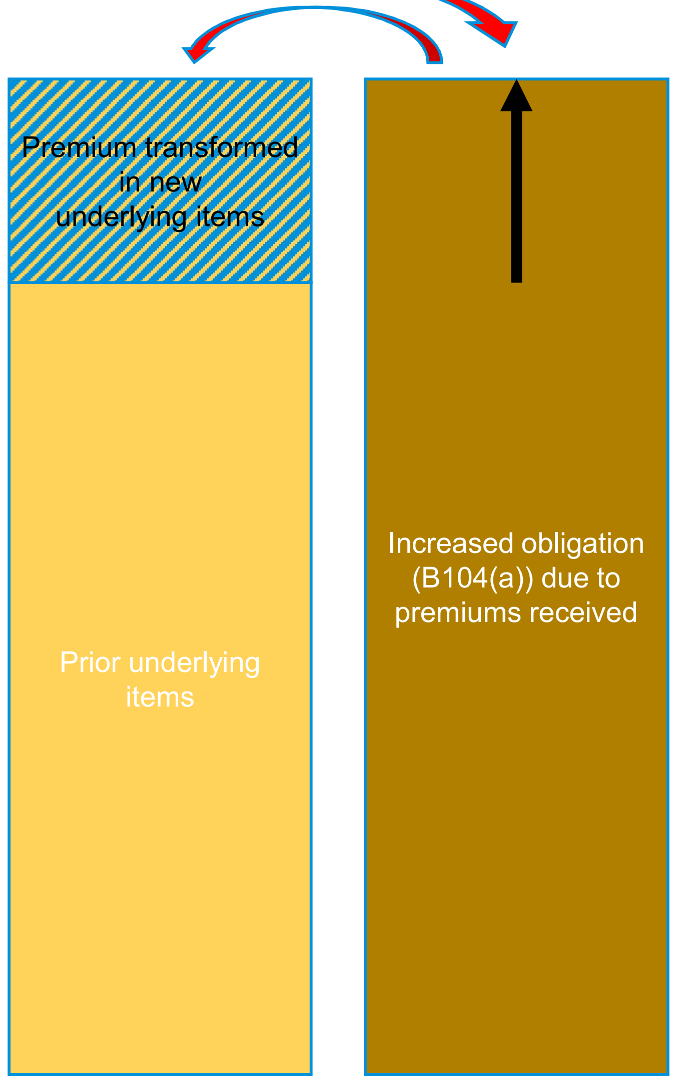




The premium is transformed into u/is according to contract, the resulting u/is are added to the existing u/is and the premium payment increases as well the net obligation of the insurer to the p/h.

Often, immediately at addition, charges are deducted from the amount added, being part of insurer‘s share, to be considered in applying IFRS 17.B101.

Changed situation



Changes in the value of u/is: Withdrawal

Changed situation

Prior situation

Underlying items

Obligation (B104(a))

Contractual withdrawal for payments, cost, profit etc.

U/is moved at the contractually determined value to insurer's own funds or transferred outside the insurer (to p/h, employees, etc.)

A withdrawal is any contractual reduction of the u/is were the contractually determined value of the reduction equals the transferred amount.

Remaining underlying items

Decreased obligation (B104(a)) due to release of obligation by payment

Changes in the value of u/is: Other changes

Changed situation

Prior situation

Returns

u/is generate

Underlying items

Obligation (B104(a))

The returns generated by the u/is increase the value of the (same) u/is and as a result the obligation increases.

Subsequently, the value of the u/i might decrease since the investment return is paid in cash and the entity acquires further u/is with that amount.

Prior underlying items with a higher value

Increased obligation (B104(a)) due to higher value of same u/is as before

Conclusion

- IFRS 17.B128(c) clarifies that the linkage of the value of the obligation to the values of each of the u/is represents financial risk.
  - Changes in the contractual obligation **caused by** changes in the **value** of **any one** of the u/is are assumed to be an effect of financial risk. This is to be seen as an accounting convention to simplify accounting, it is not saying, that this actually meets the definition of financial risk, since the change of the value, e.g. of a reinsurance contract held asset held by the entity due to the incurrence of a claim from the contract measured, can meet clearly the definition of non-financial risk.
  - Changes in the **composition or volume** of u/is contractually **caused by** the contractual obligation do not represent financial risk but is a contractual incurrence.
  - IFRS 17 differentiates precisely between
    - “the underlying items” or “pool of underlying items”, meaning all u/is related to the contract as e.g. in IFRS 17.B101(a) or (b) and
    - “changes in the value of underlying items” in IFRS 17.B128(c), i.e. it is the individual u/i, which changes its value, not only the total value of the pool of u/is e.g. due to change in composition
    - “returns on any underlying items” in IFRS 17.B72 and following paragraphs (referring not necessarily to VFA-contracts), i.e. meaning “all, wherever there is one”.

Can a variable fee be fixed?

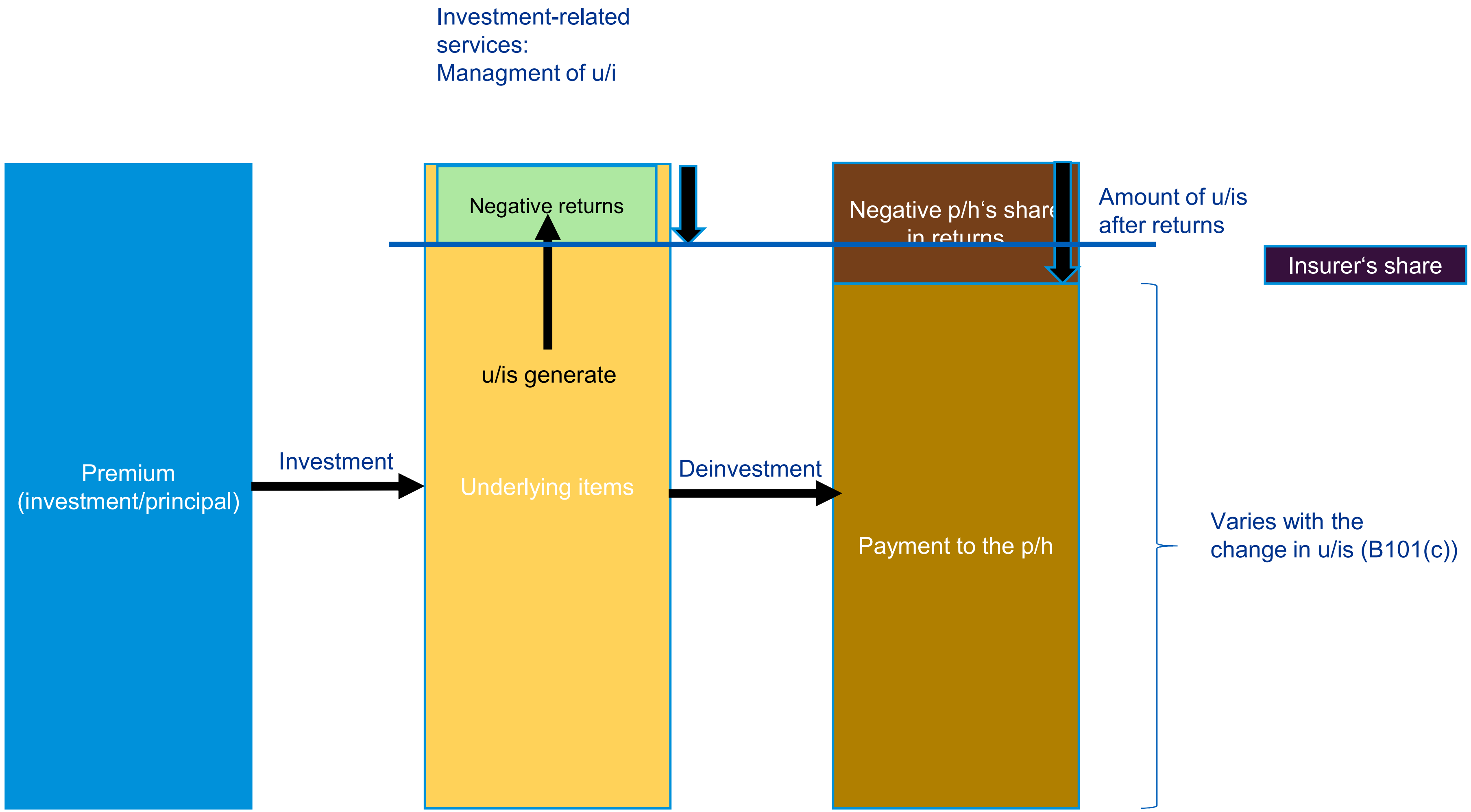
- IFRS 17.B104(b) refers to a “variable fee”, a phrase which is only picked-up in IFRS 17.B110 (“variable nature of the fee”), but refers only to the fact that the **fee may vary over time** (which can be caused not only by the varying amount of the share in the returns but as well by the varying cash flows not varying with the u/is). The phrase is not appearing anywhere else, particularly not in the definition of direct participating contracts in IFRS 17.A and B101.
- Relevant is less whether the fee (IFRS 17.B104(b)) can vary, but merely whether the **insurer’s share in the returns on the u/is (IFRS 17.B104(b)(i)) needs to vary with the returns** to meet the definition of a direct par contract. There is no indication anywhere that this is required.
- The entire discussion of developing the VFA did not refer to a need that the insurer’s share in returns on the u/is varies with the u/is. The phrase “variable fee” is used only to emphasize that the **fee may vary, even with the performance**, without causing an issue.

What are negative returns?

- IFRS 17.B104 does not exclude that returns may be negative, i.e. it does not require a floor (minimum guarantee) in the amount of the premiums less contractual charges.
- Negative returns frequently incur in case of unit-linked contracts since there is only one type of underlying item but as well for other contracts.
- They can result in a negative fee of the insurer but as well the contract may permit to deduct a fee from the principal even if the return is negative or insufficient to cover the contractual fee, i.e. the fee may makes the policyholder’s share even more negative.
- Negative returns need to be considered in applying IFRS 17.B101(b) and (c).

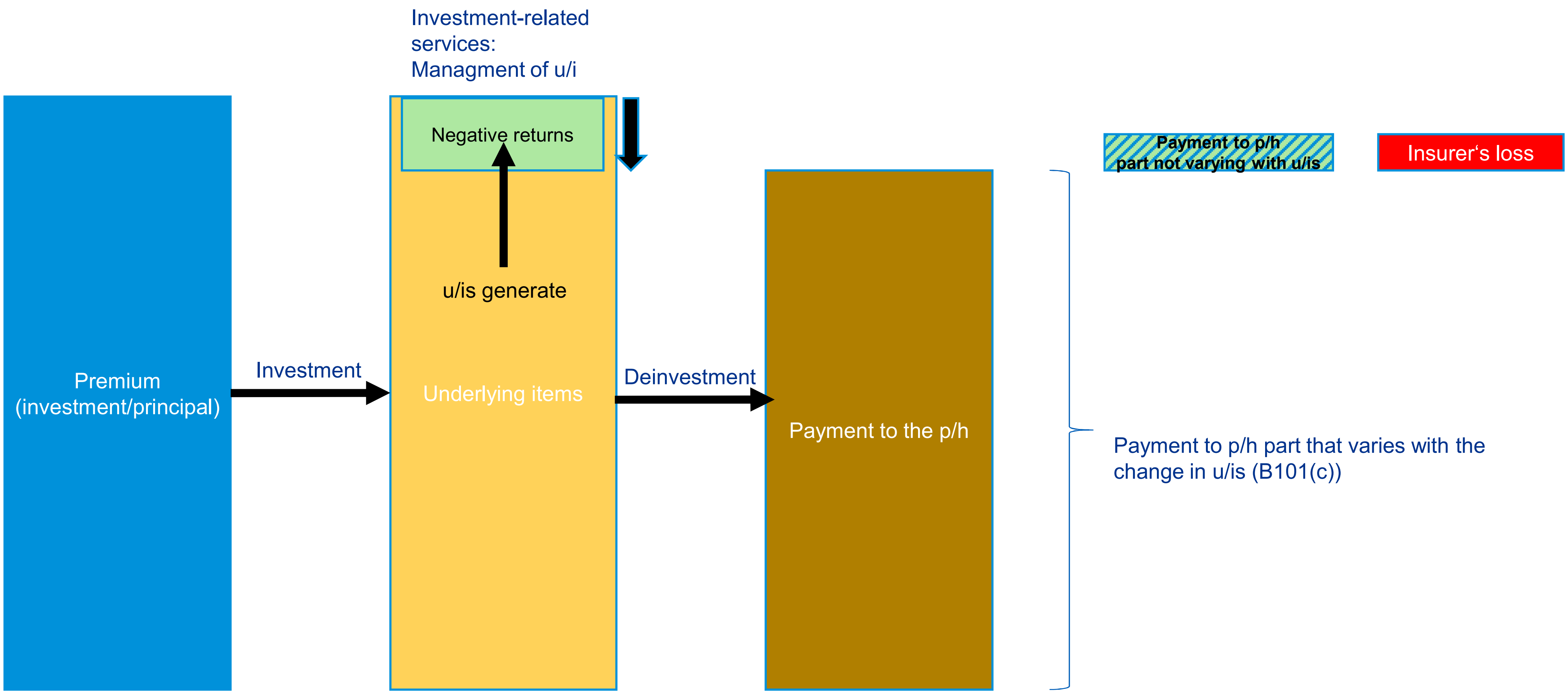
IFRS 17.B104 (AP 2A March 2015 para. 15, IFRS 17.BC242(a)/(b))

Returns can be negative but the insurer may nevertheless retain a profit, e.g. in unit-linked without any minimum guarantee.



IFRS 17.B104 (AP 2A March 2015 para. 15, IFRS 17.BC242(a)/(b))

Returns can be negative, the insurer may share in the loss, e.g. here, the p/h receives more than the u/i if the return is negative. The amount paid in excess of the u/i, financed by the insurer (causing a loss to the insurer) is not varying with the u/i. Payments, or parts of payments, not financed by the u/i but by the insurer are not varying with the u/i.



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Conclusion

- Negative returns on the u/is may result, depending on the contractual determination of insurer's share,
  - nevertheless in a positive insurer's share (e.g. in case of unit-linked contracts without minimum guarantees, the insurer receives charges)
  - in a loss to the insurer.

- To note: In case of negative returns, any gain of the insurer decreases the return paid to the policyholder (makes it more negative) and therefore makes it more unlikely to comply with IFRS 17.B101(b). Any contribution of the insurer to the payment, i.e. a loss, makes it more likely, but it makes it more unlikely that IFRS 17.B101(c) is met.

"Cash flows vary"

- **IFRS 17 uses following phrases after those words:**
- IFRS 17.120, B75, B77, B79, B80, B85, B104(b)(ii), B108, B113 "based on the returns on underlying items"
- IFRS 17.B48 "based on returns on assets and other cash flows"
- IFRS 17.B65(c) "depending on returns on underlying items"
- IFRS 17.B72, B74(a) "based on the returns on **any** underlying items"
- IFRS 17.B74(b) "based on the returns on **any** financial underlying items"
- IFRS 17.B76 "with returns on underlying items"
- IFRS 17.B76 "vary solely based on the returns on **the** underlying items"
- IFRS 17.B83, B84 "based on the returns of **the** assets in the reference portfolio"
- IFRS 17.B98 "based on specified asset returns"
- IFRS 17.B101(c) "with the **change in fair value** of **the** underlying items"
- IFRS 17.B107 "with the **changes in fair value** of **the** underlying items"
- IFRS 17.B108 "with the **changes in the fair value** of **the** underlying items"
- **There is not actually a special intention noticeable included in a specific phrase, except:**
  - "any" means any one, disregarded which
  - "the" means all underlying items, i.e. including all items which qualify as such.
  - "change(s) in (the) fair value" clarifies that the insurer cannot retain any of the actual value changes of the items (the fair value) but that the p/h (or any other p/h on behalf of the p/h) shares effectively in the fair value.

Which cash flows vary with u/is?

- IFRS 17 does not define the phrase “cash flows varying with u/is”.
- IFRS 17.B104 (see next slide) indicates that cash flows varying with u/is are all cash flows arising under the contractual obligation to the p/h which are not part of the variable fee, i.e.
  - **cash flows fulfilling the obligation to pay to the p/h the u/is**, i.e.
    - the repayment of the principal and
    - the payment of p/h’s share in the returns on the u/is
    - to the p/h (or on behalf of the p/h to another p/h).

IFRS 17.B104

In formula:

Changes do not adjust the CSM

IFRS 17.B111

Changes adjust the CSM

IFRS 17.B112

Changes adjust the CSM, except releases

IFRS 17.B113

entity's obligation to the policyholder

=

obligation to pay the policyholder an amount equal to the fair value of the underlying items

−

[

amount of the entity's share of the fair value of the underlying items

−

fulfilment cash flows that do not vary based on the returns on underlying items

]

= Total FCF

= IFRS 17 value of u/is

IFRS 17.B101

This must be a
Variable Fee
not ownership interest

!

⇔

entity's obligation to the policyholder

−

fulfilment cash flows that do not vary based on the returns on underlying items

=

obligation to pay the policyholder an amount equal to the fair value of the underlying items

−

amount of the entity's share of the fair value of the underlying items

= Total FCF

= IFRS 17 value of u/is

Applying logic: =

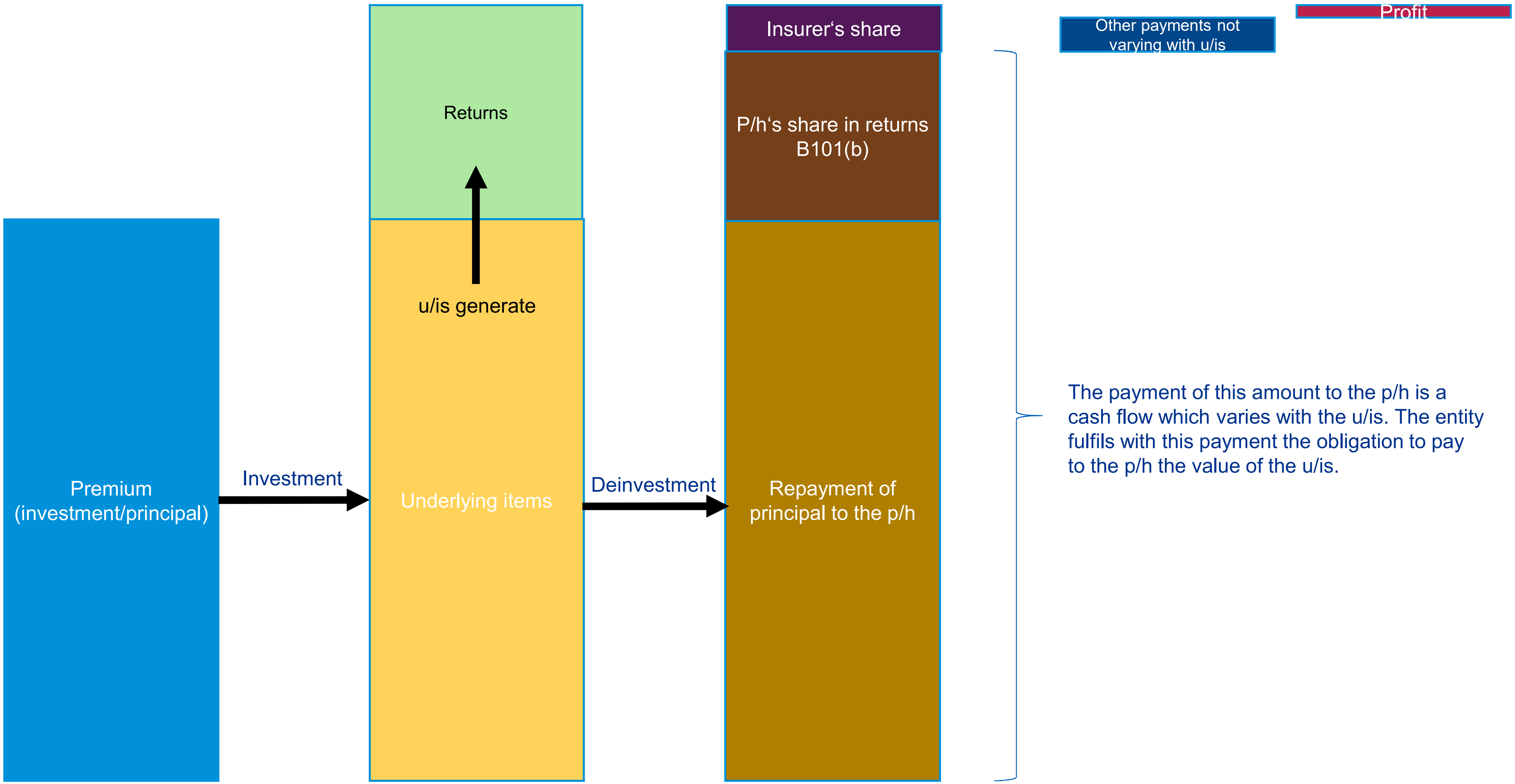
fulfilment cash flows that vary based on the returns on underlying items

FCF that vary based on the returns on underlying items are those FCF, whose payment fulfils the obligation to pay the policyholder an amount equal to the fair value of the u/is and are not entity's share.

Which cash flows vary with u/is?

- How to differentiate a payment varying with u/is to the p/h, i.e. a payment out of p/h's share from a payment to the p/h out of the insurer's share?
  - If the payment out of p/h's share hadn't been paid, it would remain in the u/is, i.e. **it would remain an obligation** to be paid to the p/h according to IFRS 17.B104(a) (a part might be insurer's share).
  - If the payment out of insurer's share hadn't been paid, **it would be insurer's profit**.
- Example: German life insurance (p/hs share in mortality result)
  - A death benefit of 1,000 reduces the u/is, the total investments (including bank account), by 1,000. Normally most (if not all) of the 1,000 would be paid nevertheless later to p/hs, if the death hadn't incurred. The non-incurrence of an expected death might simply increase slightly insurer's share in the u/is.
- Example: UK unit-linked (p/h do not share in mortality result)
  - A death benefit of 1,000 is paid out of the mortality charge made by the insurer. If the death hadn't incurred, the 1,000 had been part of the profit of the insurer.

Cash flows varying with u/is

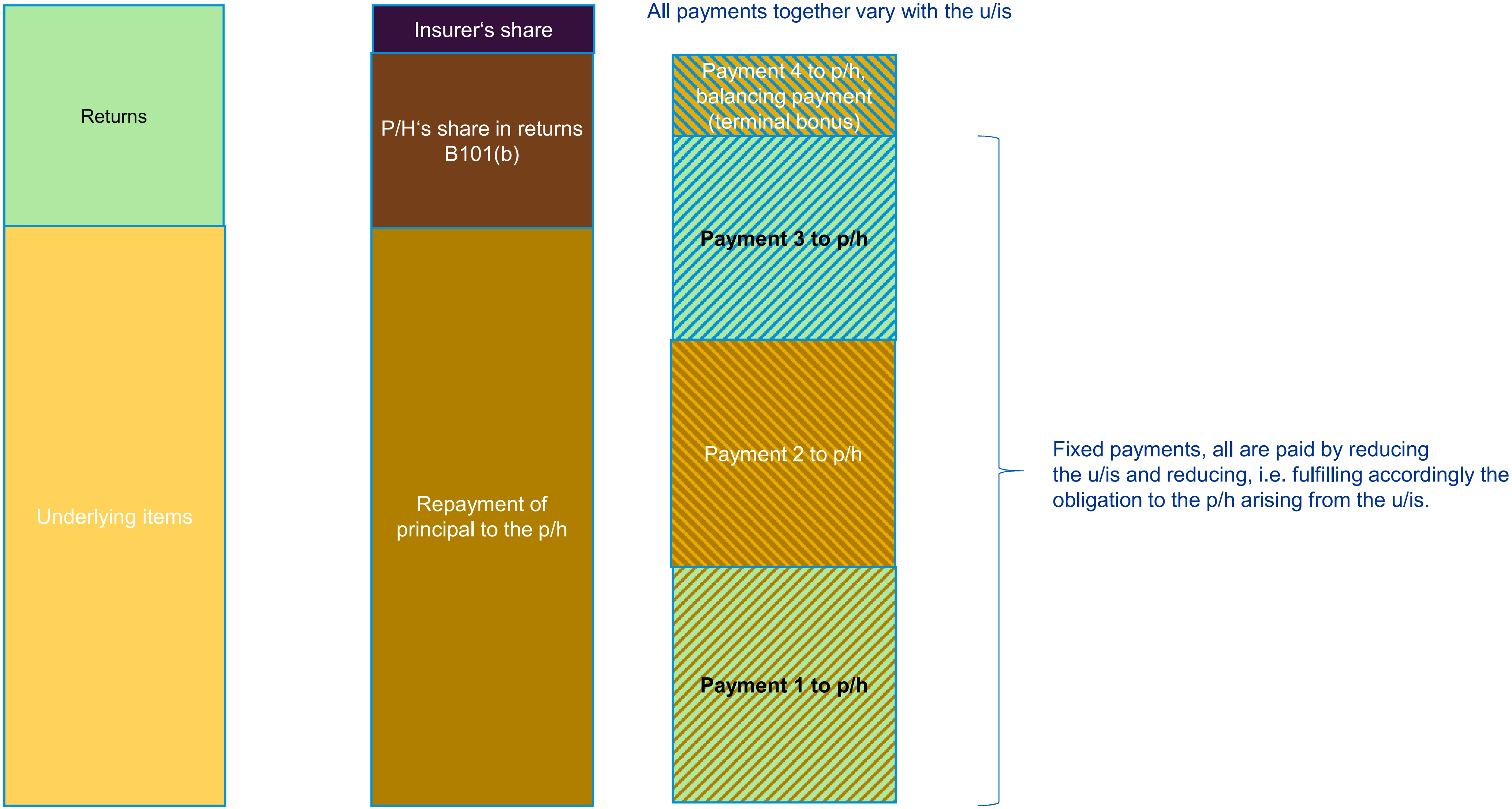


Which cash flows vary with u/is?

- Since any cash flow meeting the obligation to pay the u/is to the p/h are “cash flows varying with the u/is”, as well fixed cash flows can be such.
  - But only if there is a sequence of cash flows out of the u/is and the last cash flow balances the total amount of cash flows to the u/is.
- There is a contractual approach to determine insurer’s share (can be to some extent discretionary). Anything paid out, not agreed with the p/h (e.g. a charge to third parties based on a contract with those), of that share is not a cash flow varying with u/is (even if it is indexed with the u/is).

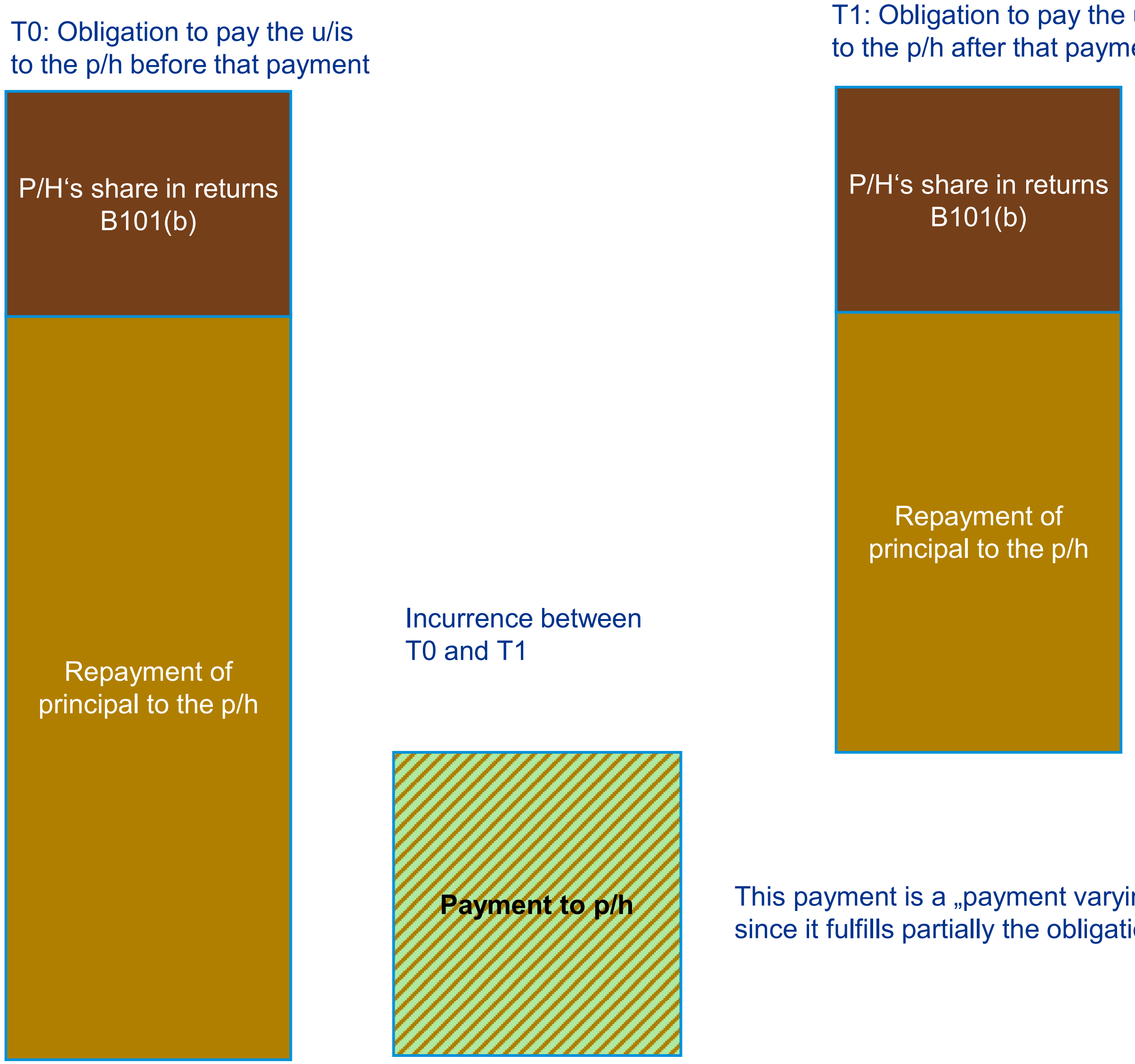
IFRS 17.B104 (vary with)

What is the meaning of a „cash flow varying with u/is“? Is it only one payment or can the overall obligation be paid in several installments, where some amounts are fixed amounts with a balancing terminal payment? Example: Unit-linked contract, where the policyholder withdraws monthly – up to extinguishing – fixed amounts and the residual is paid at the end.



IFRS 17.B104 (vary with)

The payment of a cash flow that varies with the u/is reduces the u/is and accordingly as well the obligation to pay the u/is to the p/h.



This payment is a „payment varying with the u/is“
since it fulfills partially the obligation to pay the u/is to the p/h.

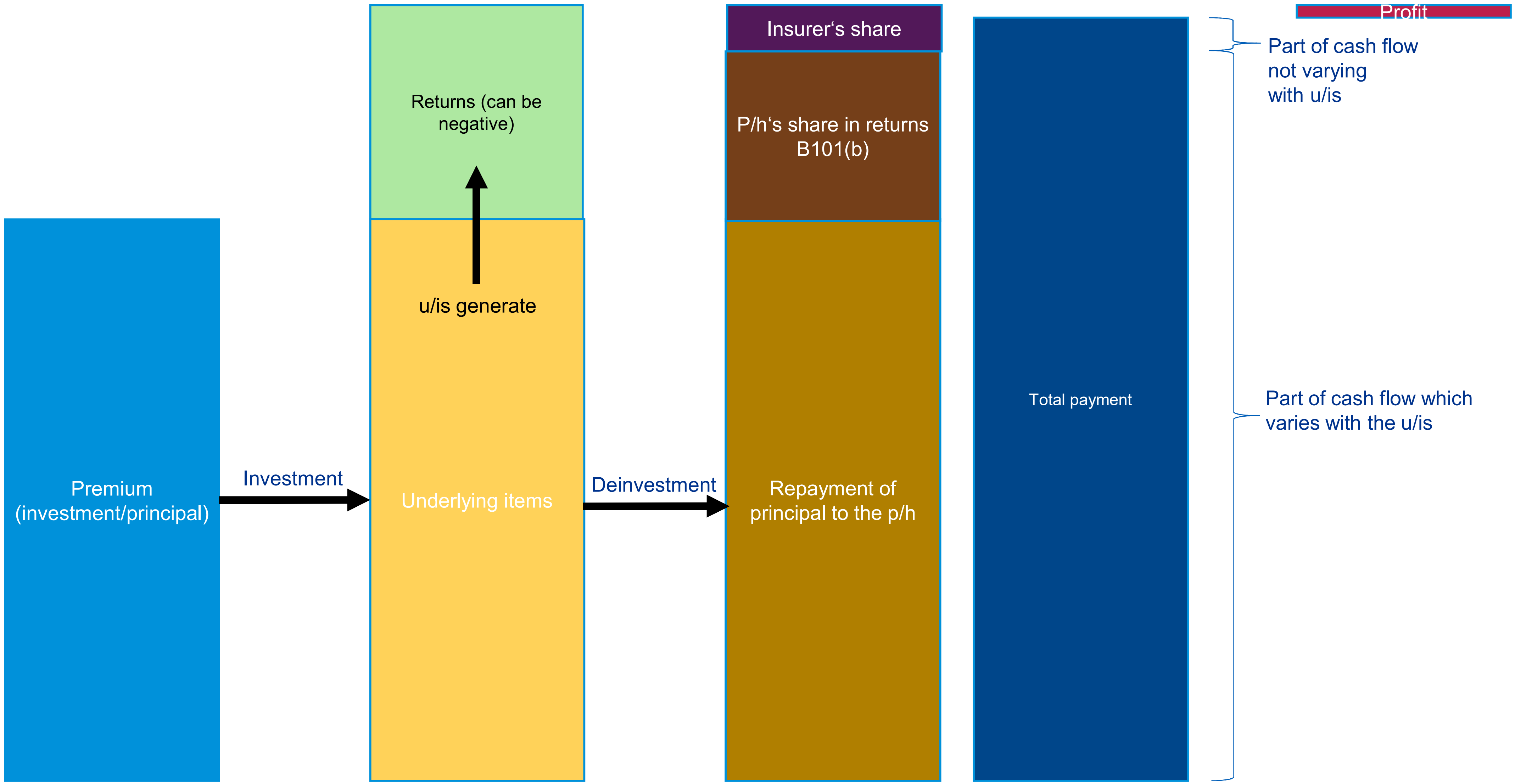
Conclusion

- The payment meeting the obligation to pay to the p/h the fair value of the u/is (IFRS 17.B104) can be provided in **installments**, where each installment is a fixed amount, except the last one, which balances the total payments to the p/h share in the u/is.
- The term “vary with the changes in the fair value of the u/is” refers to all payments which are made to the p/h in fulfilling the obligation to pay to the p/h the fair value of the u/is, even if an individual installment payment itself is fixed.
- Since a payment varying with u/is is reducing the obligation to pay the u/is, it is, except a certain insurer’s share in the u/is, neutral to the insurer. A payment not varying with the u/is reduces fully the amount which the insurer otherwise could retain as profit, i.e. causes fully a loss to the insurer.

Can one single cash flow contain parts varying and not?

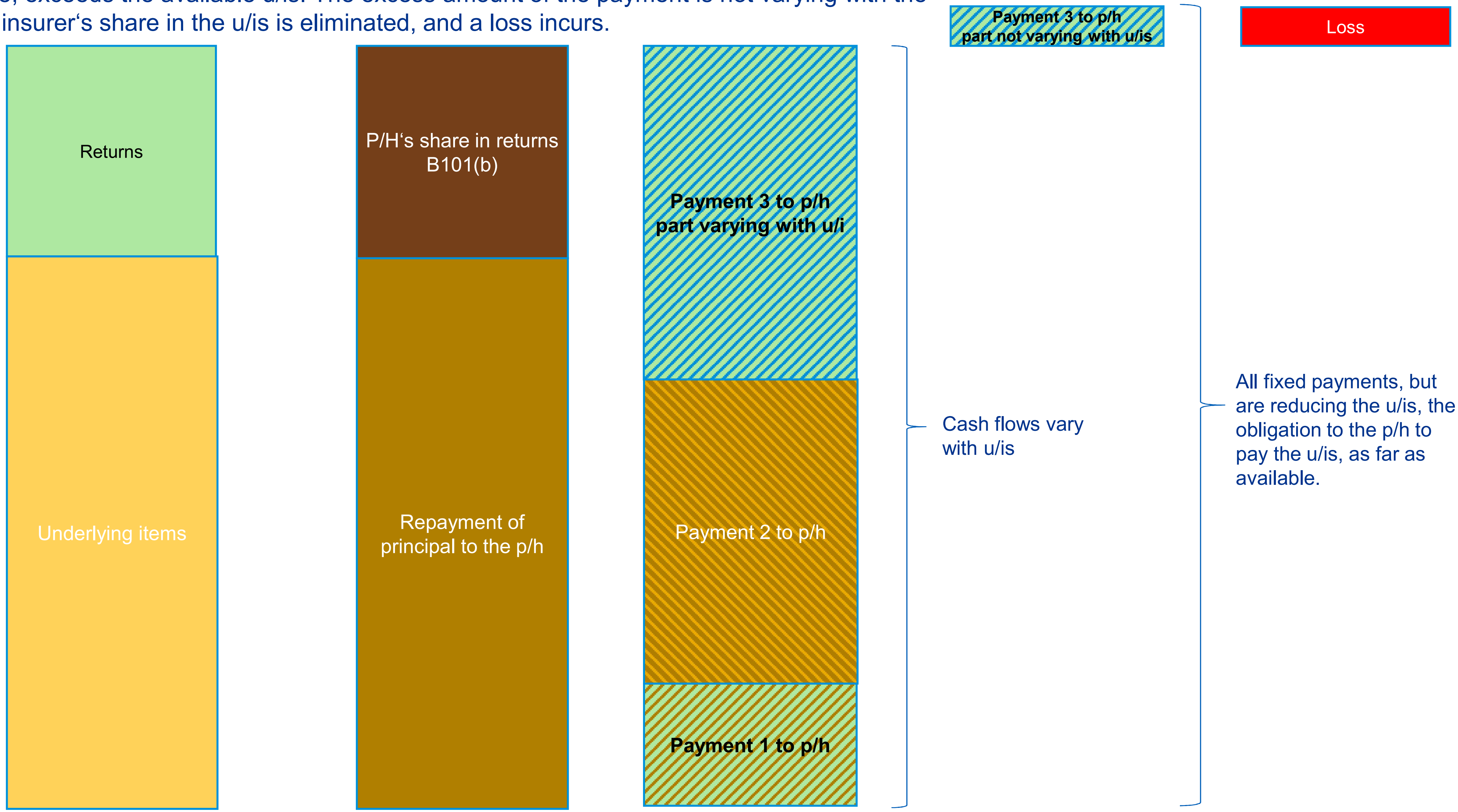
- Most common case: UK unit-linked death payment, includes the repayment of the u/is, i.e. varying amount, and the fixed death benefit paid on top, either
  - a fixed amount paid on top or
  - topping up the variable amount to the agreed death benefit (i.e. a variable top up amount, negatively correlated to the value of the u/is).
- But as well in case of traditional par contracts, a payment may include the repayment of the u/is and an amount on top (either fixed or negatively correlated to the value of the u/is), causing a loss to the insurer since not covered by the u/is.

Cash flows partly varying with u/is and partly not

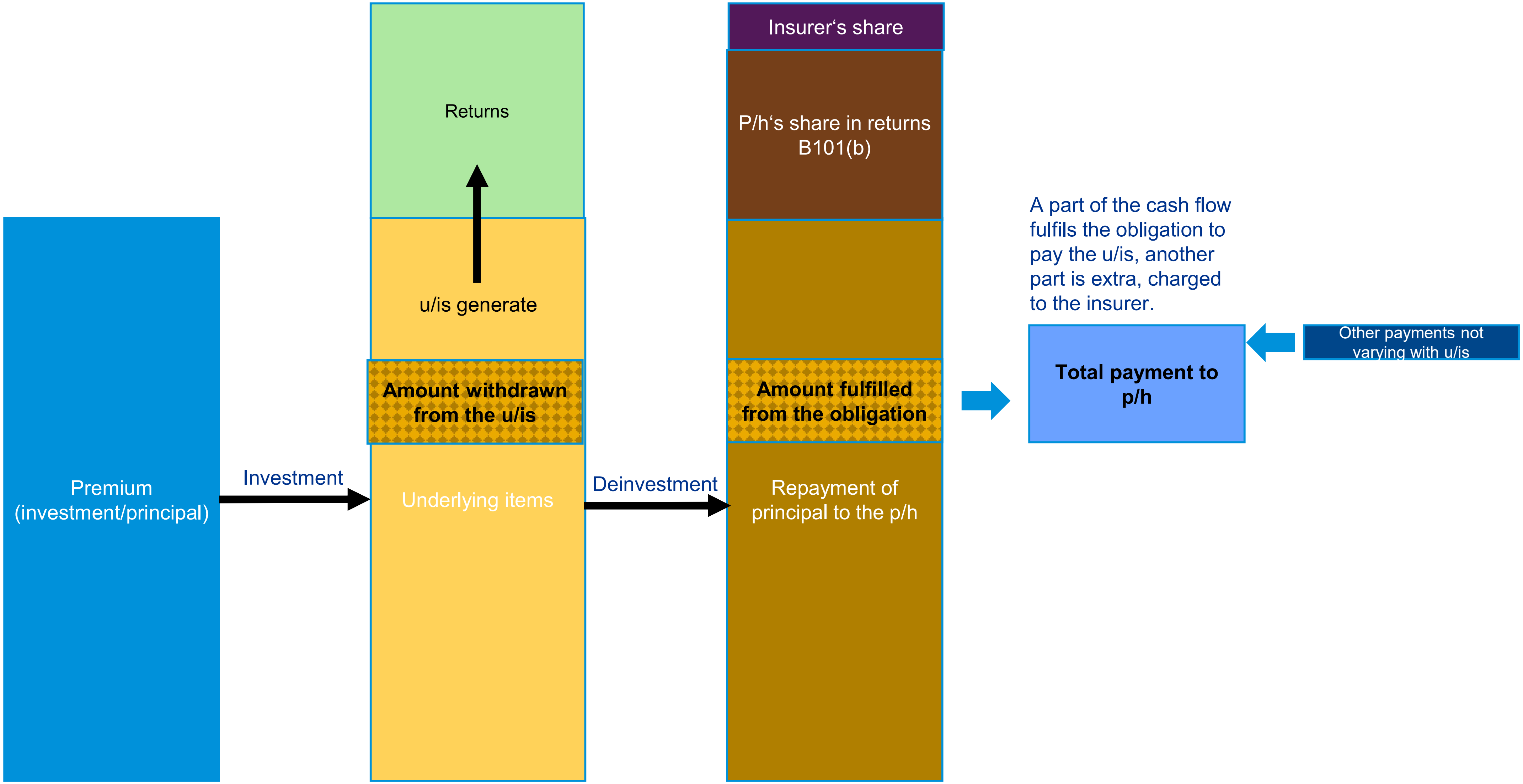


IFRS 17.B104 (vary with)

Payment 1-3 reduce the obligation to pay the u/is to the p/h. But payment 3, e.g. due to a minimum guarantee, exceeds the available u/is. The excess amount of the payment is not varying with the u/is. The insurer‘s share in the u/is is eliminated, and a loss incurs.



Cash flows partly varying with u/is and partly not



Conclusion

- A payment to the p/h can be **divided** in the part reducing the obligation to pay the fair value of the u/is to the p/h (i.e. varying with the change in the fair value of the u/is) and a part paid in excess (not varying), accordingly to be covered by the insurer outside the u/is.

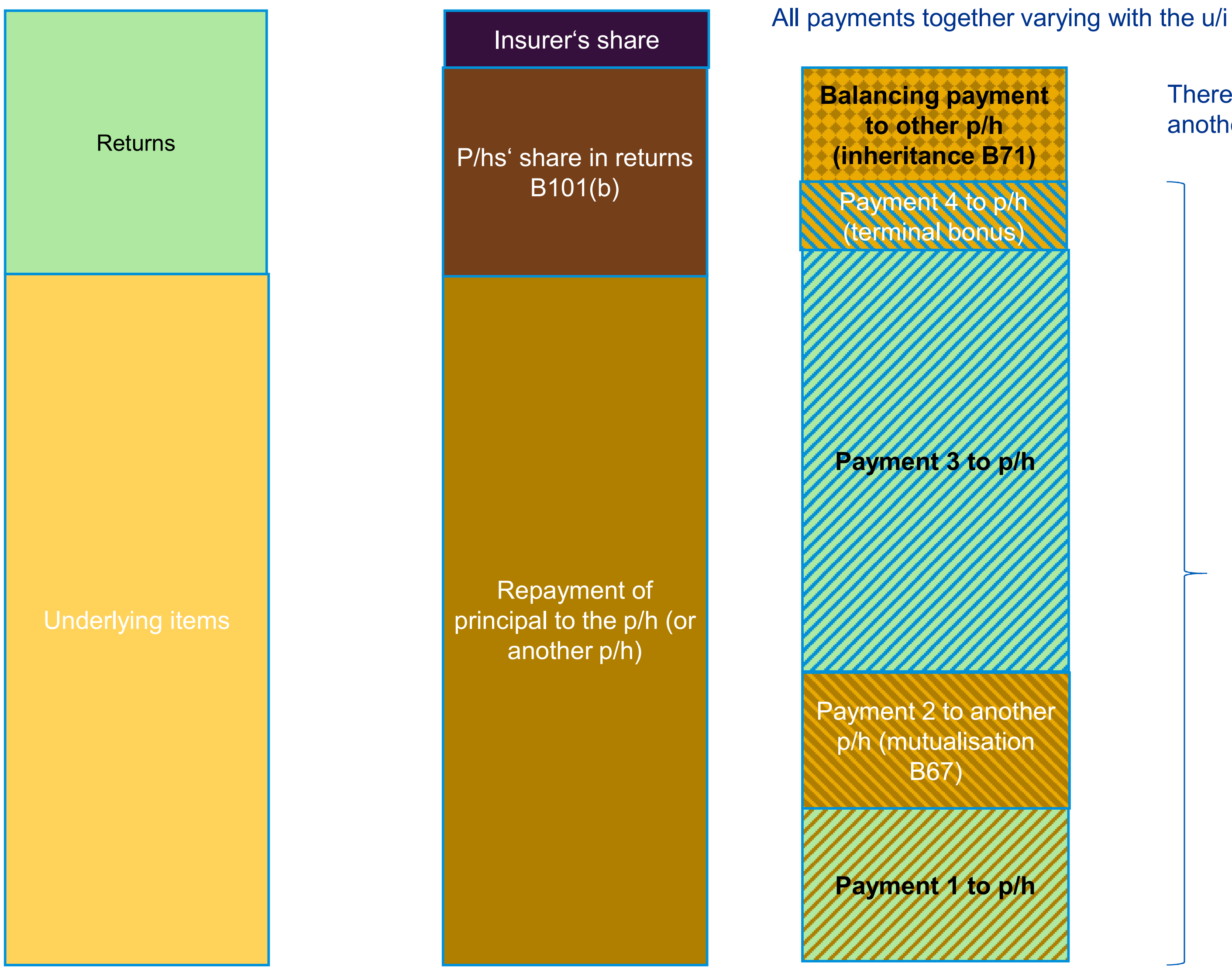
- Minimum guaranteed payments may not be in the money and accordingly paid as part of the normal payment of the fair value of the u/is to the p/h. If minimum guaranteed payments are in the money, i.e. only partly covered by the u/is, the payment of that part covered by the u/is fulfills the obligation of the insurer to pay the fair value of the u/is to the p/h, the remaining part is an additional obligation (even if it is negatively correlated with the u/is) not varying with u/is.
- One payment can fulfil several obligations and being divided accordingly.

Can a varying payment be made to another p/h?

- IFRS 17.B65(c) clarifies that payments varying with u/is can be paid, in fulfilling the obligation to pay the u/is, to another p/h, **on behalf of the first p/h**. It is an **obligation to the first p/h** which is met by the payment to the other p/h. (To note, the word p/h is the person which the entity is obliged to compensate, there can be more than one)
- That is quite common in traditional par contracts that the amounts paid are actually fixed based on bonus declarations made up to a year before and that the balancing amount to the current fair value of the u/is remaining is inherited to other p/hs (IFRS 17.71).
- But as well death payments to a p/h may be made by reducing the u/is of a surviving p/h (mutualisation).

IFRS 17.B101 (vary with) in traditional collective par (B71)

Policyholder inherits excess p/h's share to other policyholders

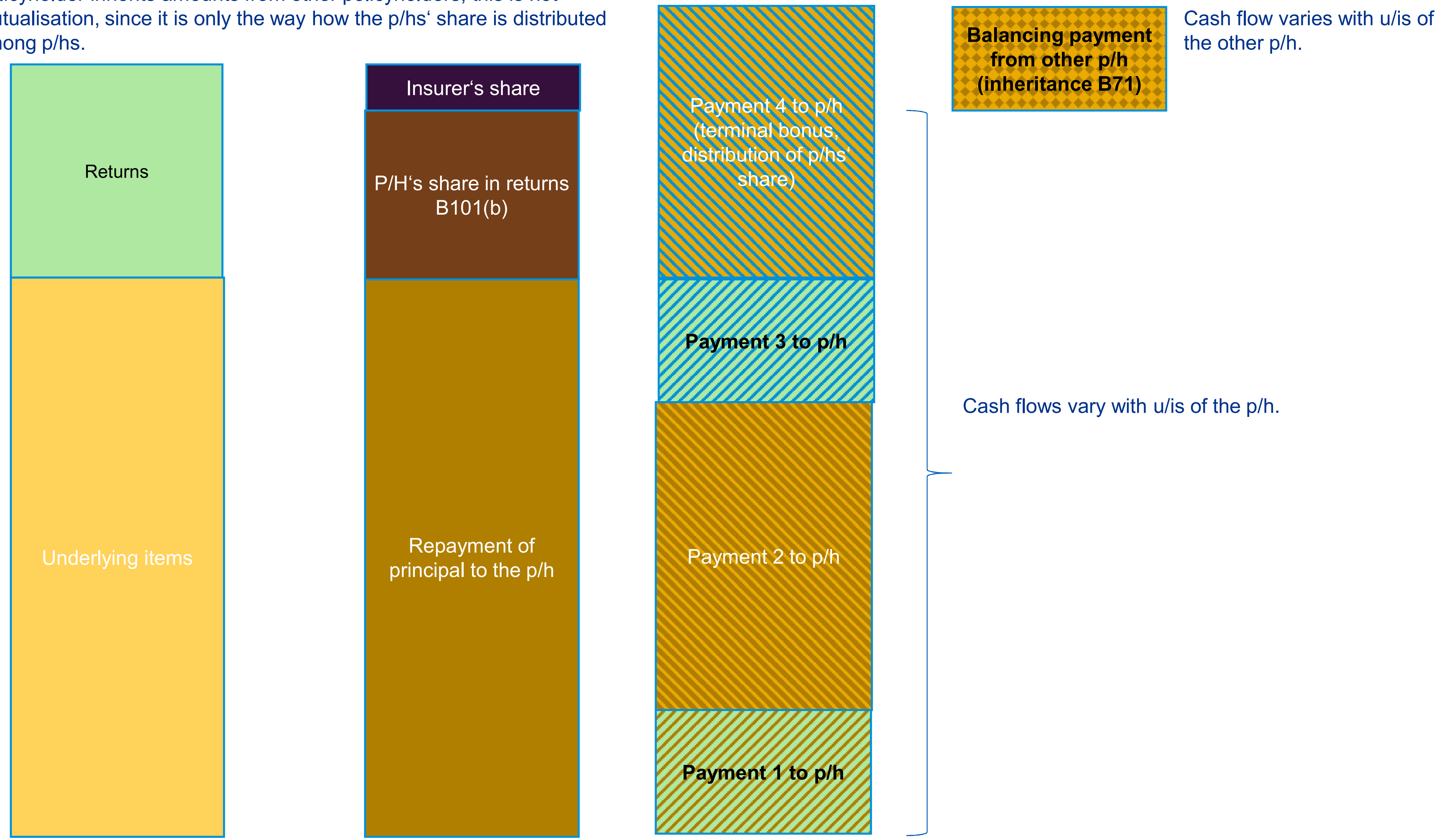


There needs to be an obligation to pay this amount to another p/h under the contract with the generating p/h.

May be fixed payments or depending on returns, but all are paid by reducing the u/is and reducing accordingly the obligation to the policyholder arising from the u/is.

IFRS 17.B101 (vary with) in traditional collective par (B71)

Policyholder inherits amounts from other policyholders, this is not mutualisation, since it is only the way how the p/hs‘ share is distributed among p/hs.



Conclusion

- The payments making up to the total value of the u/is can be made to another p/h (IFRS 17.B65(c)), particularly the balancing final payment can be inherited to other p/hs (IFRS 17.B71),
- the p/h may receive as well inherited amounts from other p/h and
- all those payments are considered in the measurement at the contract generating the value of the u/is as payment varying with the u/is (IFRS 17.B65(c)) rather than at the contract expected to receive the payment, since that is the contract to which the entity is originally obliged.
- Subsequently the issue of inheritance is discussed in more depth, not only referring to the issue of “varying cash flows”.

IFRS 17.B104 Inheritance

- In some traditional participating contracts, subsequently referred to as **participating contracts with collective allocation**, the obligation of the insurer under the participation feature refers to an obligation to the collective.
- The insurer is **obliged under the contract** to allocate p/h's share to participating p/hs in the same collective in form of an additional payment, but there is no specific obligation regarding amounts to be paid to the contract.
- The insurer has a far reaching **discretion** when and to whom the p/h's share is subsequently allocated.
- The obligation under the respective contract is **fulfilled**, when the insurer allocates the amount to a p/h of the collective, whom ever and when ever.
- Allocating the amount to a p/h creates a **new obligation** to that p/h.
- That is in line with IFRS 17.B71. Unallocated amounts remain part of the LRC of the contract which generated the obligation. At allocation, they are no longer part of that LRC since the respective obligation is fulfilled.
- The allocation of a p/h's share to another p/h as additional benefit (i.e. increasing the obligation there) is referred to as "**inheritance**".

IFRS 17.B104 Inheritance

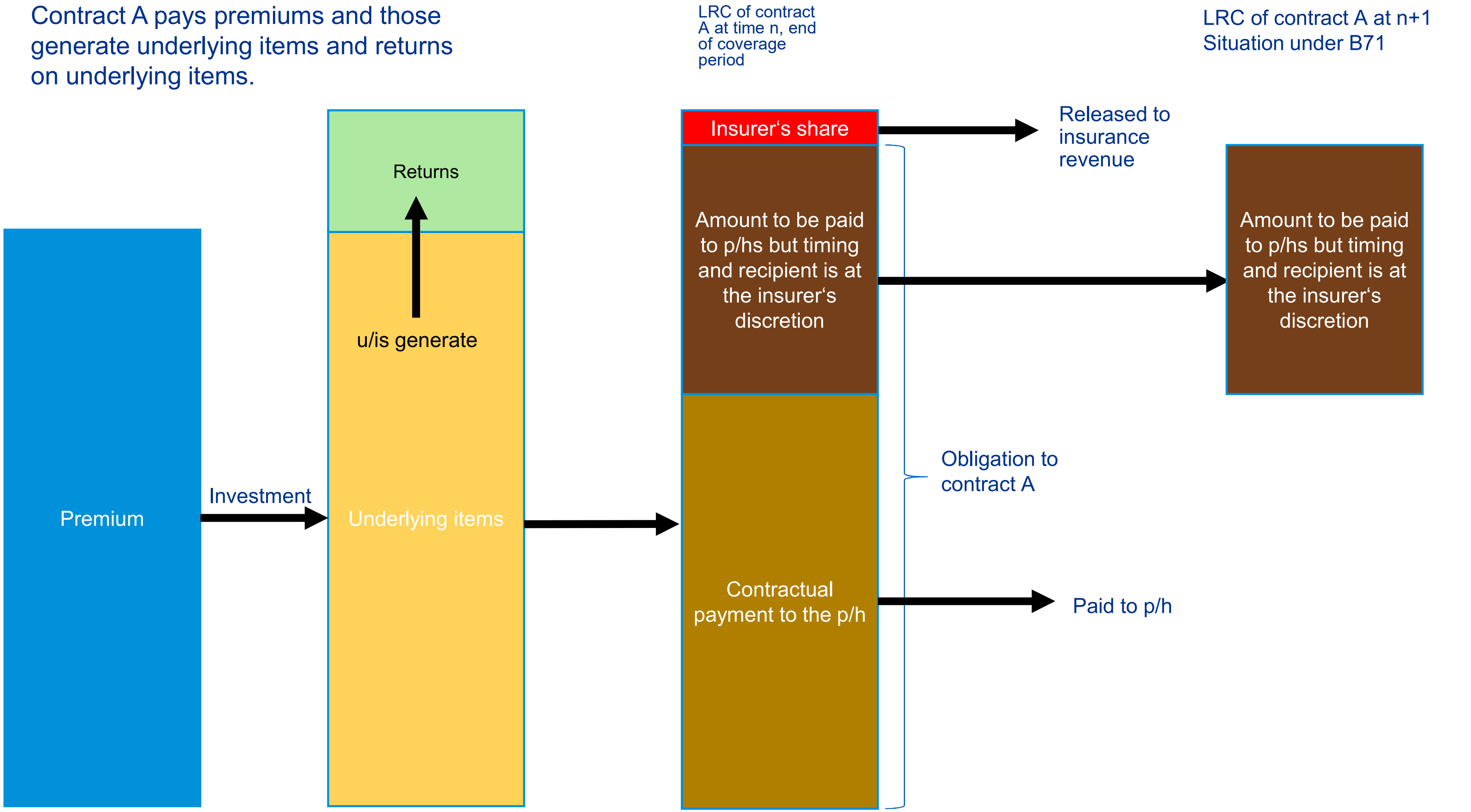
- In case of inheritance, the CSM of the inheriting contract remains unchanged.
- The CSM of the receiving contract does not change directly by the allocation.
  - However, the allocated amount may be, based on the terms of the contract exchanged to a promise of services and the exchange rate may include a service margin for the insurer with the result that the allocation creates a CSM related to the services to be provided in future for the allocated amount.
  - In some cases, the allocated amount might not to be sufficient to cover the acquired services, resulting in reduction of the CSM.

IFRS 17.B104 Inheritance

- The amount inherited to another p/h is not a substantial obligation to that p/h of the insurer before it is allocated, i.e. it is outside of its contract boundary.
- At allocation, it crosses the contract boundary.
- Since it is typically
  - part of the same legal contract
  - of similar risk and managed together with the existing contract and
  - does not extent the contract boundary substantially
  - it will be considered as a change in estimate.

IFRS 17.B104 Inheritance (B71)

Contract A pays premiums and those generate underlying items and returns on underlying items.



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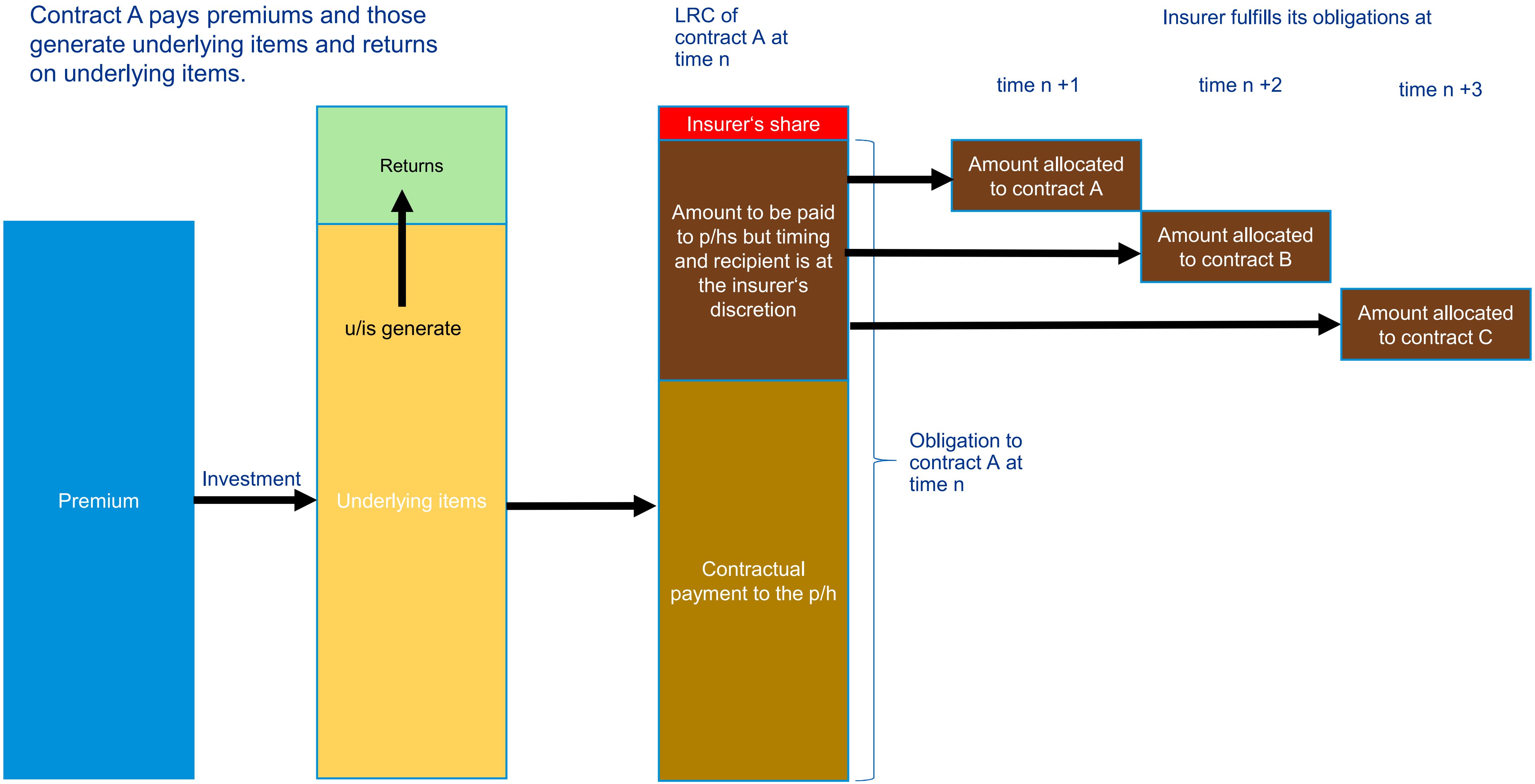
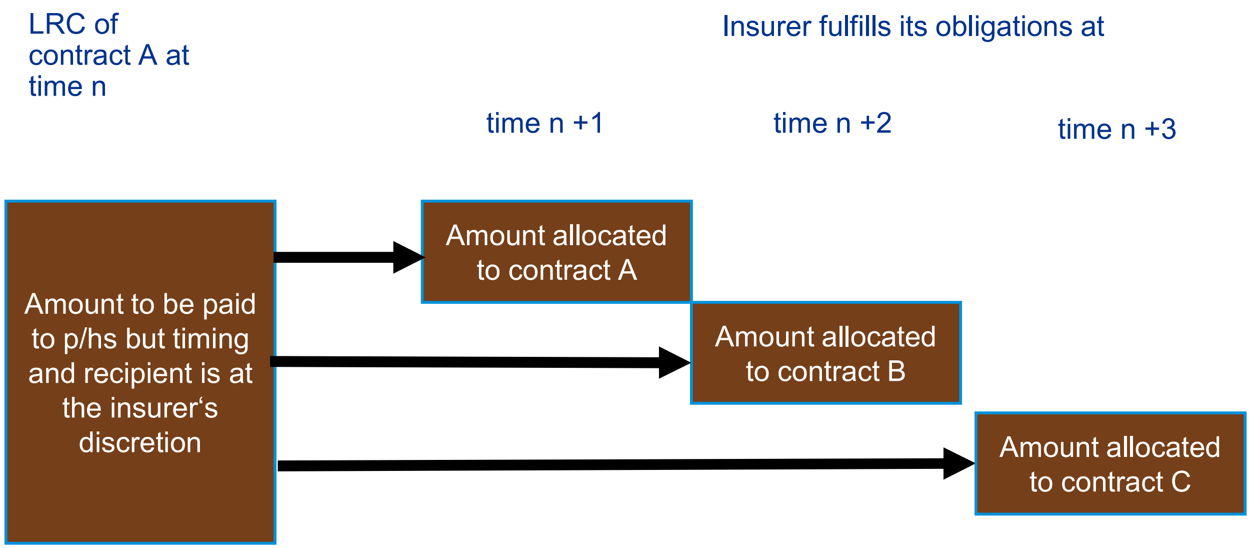
IFRS 17.B104 Inheritance (B71)

Contract A pays premiums and those generate underlying items and returns on underlying items.



IFRS 17.B104 Inheritance: Bookings



At the date of allocation, insurance revenue is recognized accordingly for contract A and the liability is released (except if the amount is certain to be paid to a p/h, which it is not the case if it may be used e.g. to be obsorbed for covering cost).

In the same amount, insurance service expense is recognized for contract A due to providing an implicit payment to contract A, B or C.

The allocation is a unilateral acceptance of a new legal obligation of the insurer to contracts A, B and C.

If it is immediately paid in cash, there is no further booking, the insurance service expense is a payment to the respective policyholder on behalf of contract A.

If the allocation is used to acquire services under the terms of contract A, B or C, it is assumed to be paid in cash and immediately repaid as a single premium to acquire the service. It is booked as such.

Since the acquired service is part of the same legal contract A, B or C, it is generally accounted for as a contract modification (the legal rights have changed), except if the acquired service is entirely separate and qualify for separation of an insurance component.

Before allocation e.g. to contract B, the amount allocated, even if that is expected, cannot be anticipated in measurement of contract B since the insurer has no substantive obligation to that contract in that regard before. Particularly the CSM resulting from the allocation cannot be anticipated.

Conclusion

- The allocation represents the fulfilment of the obligation under the contract and accordingly causes the recognition of insurance revenue and of insurance service expense, both at the same amount (if not certain to be paid to a p/h).
- The allocation at the receiving contract is, if used according to the terms of the receiving contract to acquire additional future services, recognized as an additional premium inflow and resulting at an equal amount in a liability including a CSM.
- The acquired service is, since it is part of the same legal contract but a result of a change in the legal rights and obligations, treated as contract modification, i.e. normally accounted for as a change in estimate and only if a distinct insurance component being account separetely for.
- The expected future additional service resulting from future allocations are not anticipated in measurement since the change in the obligation is outside the contract boundary.

What is mutualisation?

- Mutualisation is a contractual feature (IFRS 17.B67) which may reduce the current obligation of the insurer to pay under contract A (the subsidizing contract) a certain amount in response to a contractual payment to contract B (the subsidized contract).
- The difference to inheritance is that the payment under contract B need not to be an additional benefit (i.e. an additional benefit under contract B is provided instead of an additional benefit under contract A), it can be used as well to pay an amount which has to be paid under contract B in any case. It may be therefore not neutral to the insurer, whether there is such a feature or not.
- However, the insurer needs to have an obligation under contract A to pay the amount in general and only the proven presence of the payment under contract B permits the insurer not to pay under contract A.

What is mutualisation?

- It is typically represented by a participation feature referring to the collective surplus arising after paying all guaranteed minimum benefits under the contracts in the collective, i.e. a higher guaranteed payment under one contract reduces the u/is of the collective of contracts and accordingly their rights.
- IFRS 17.B68 emphasizes that such a contractual feature has to be considered in measurement as any other contractual feature affecting rights and obligations under a contract.
- IFRS 17.B68 emphasizes that the obligation to pay the amounts is to the subsidizing contract, since the amount is paid on behalf of this contract to the subsidized contract.
  - Insurance revenue is recognized at the subsidizing contract.
  - The future cash flow, to be paid under the subsidized contract is to be considered under the subsidizing contract, since it is economically a benefit under that contract.

What is full and what is partial mutualisation?

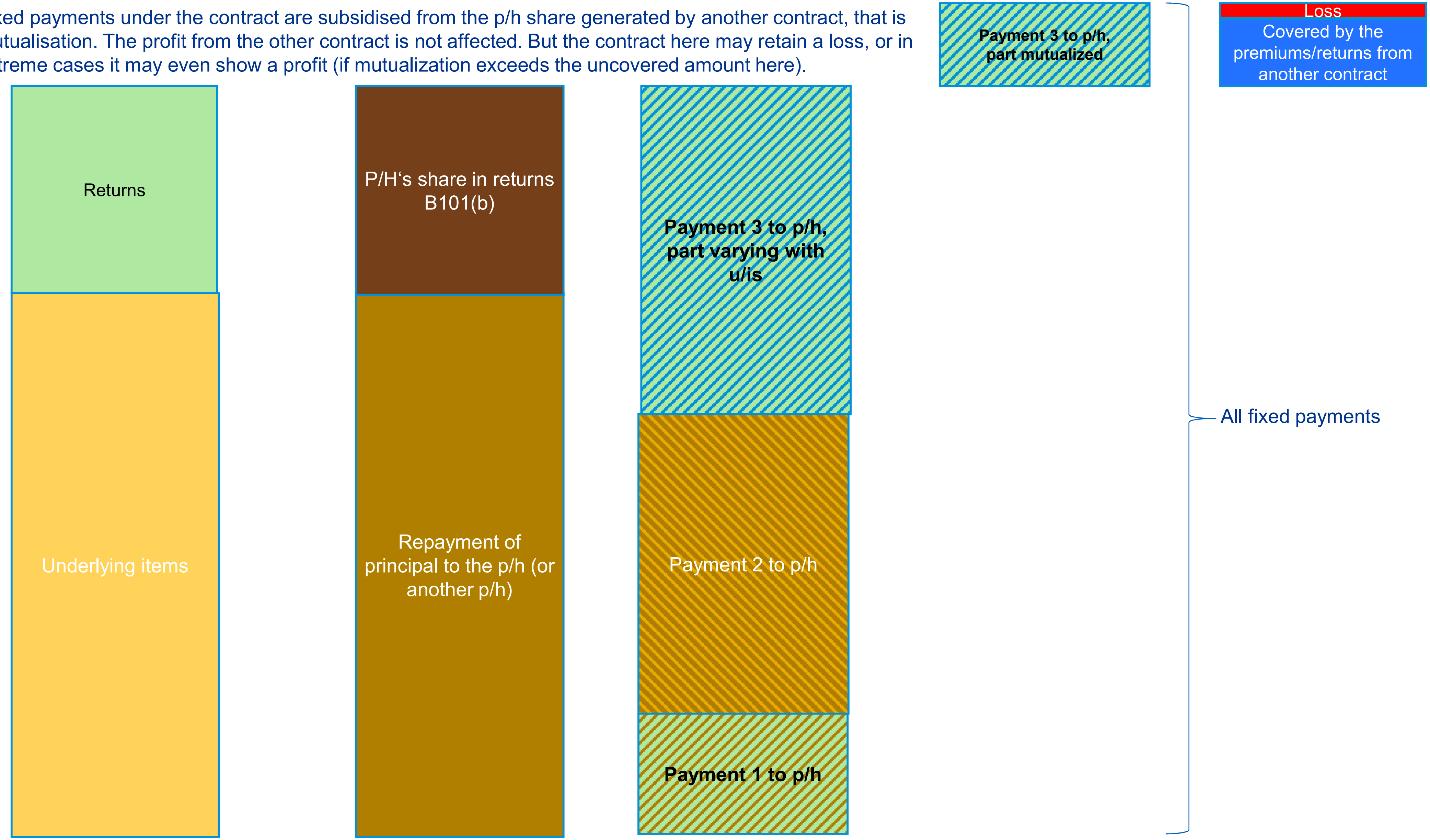
- The IASB introduced informally references to full and partial mutualisation.
- Full mutualisation means that the insurer is entitled to reduce additional benefits to other contracts in an amount that guaranteed payments under the subsidized contract are fully covered, i.e. there is no effect of these payments to the insurer. That applies if insurer's share does not vary with the u/is, e.g. since p/h receive 100% of returns or if the insurer receives (except in very extraordinary circumstances) a fixed fee.
- Partial mutualisation applies if the insurer can only partially cover the guaranteed payments, e.g. since the insurer bears 10% of any change in the u/is – in that case the reduction of the u/is due to the guaranteed payment affects at 10% insurer's share. That reduction needs to be considered in the CSM of the contract to which the guaranteed payment is to be paid.

What is full and what is partial mutualisation?

- The notion was misunderstood by some. They understood it to refer to the extent of the participation feature, i.e. does it refer
  - only to investment returns (assumed to be the meaning of partial mutualisation) and
  - to participate in all sources of “surplus”.
- To note: “mortality surplus” (and “cost surplus”) in traditional participating business does not actually represent a surplus. It is the difference between an internal mortality projection and the actual outcome, not between an amount received from the p/h and an amount paid to the p/h. Death benefits and cost are taken from the investments acquired with the premiums and reduce other benefits to be paid otherwise, except for insurer’s share.

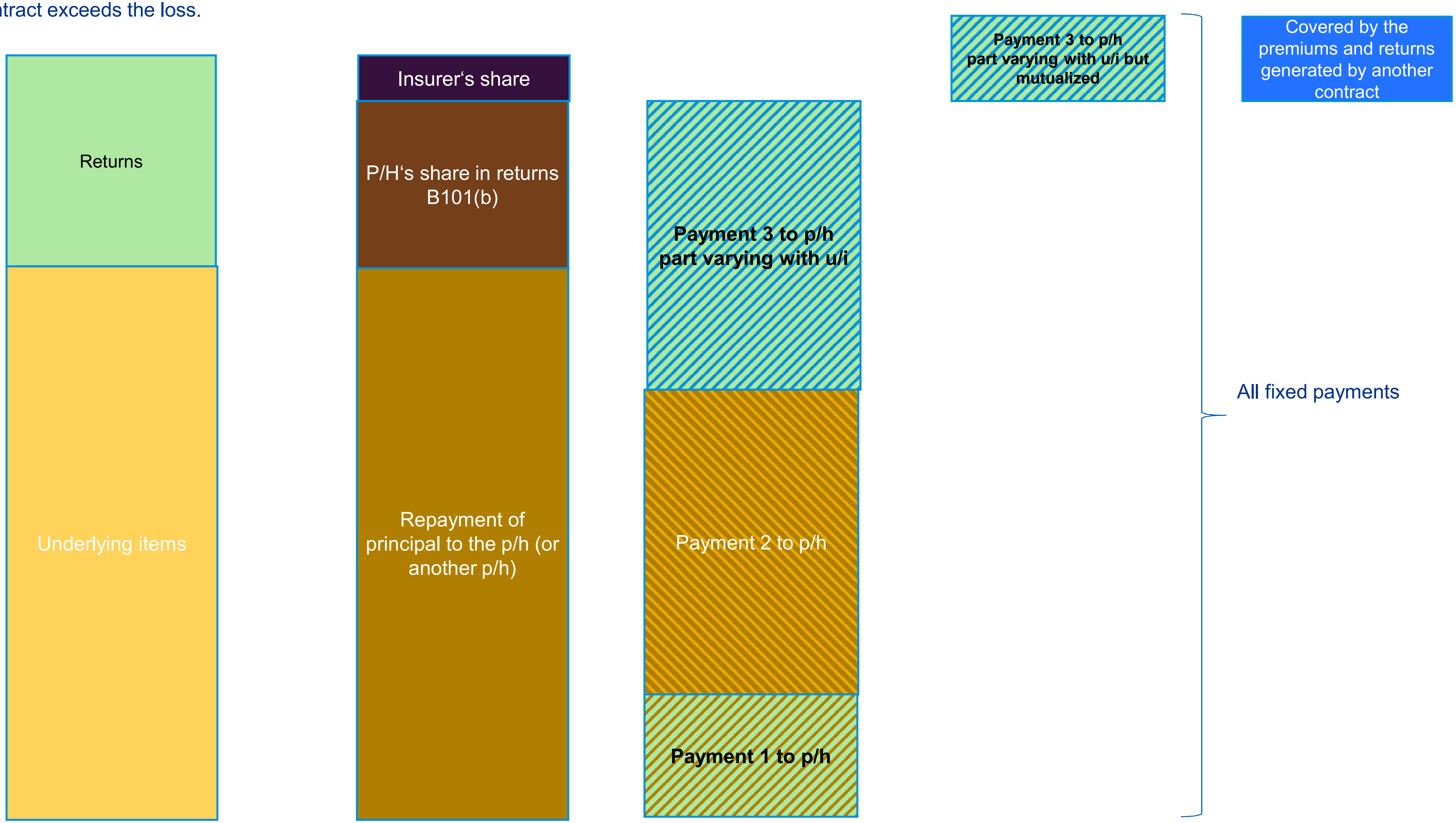
IFRS 17.B68

Fixed payments under the contract are subsidised from the p/h share generated by another contract, that is mutualisation. The profit from the other contract is not affected. But the contract here may retain a loss, or in extreme cases it may even show a profit (if mutualization exceeds the uncovered amount here).



IFRS 17.B68

This example shows the case where a subsidized contract generates profit since the subsidy from another contract exceeds the loss.



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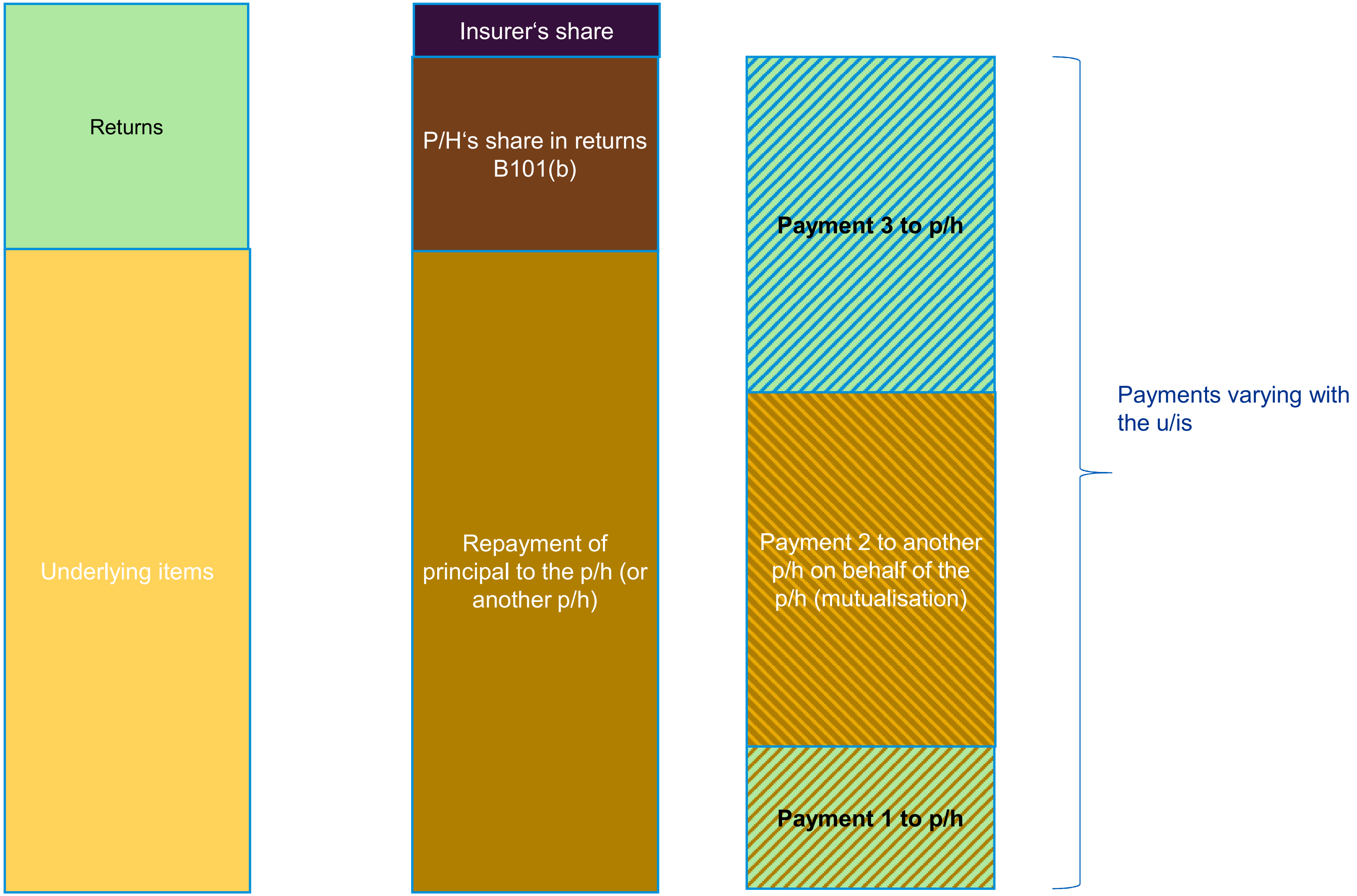
IFRS 17.B68

This example shows the situation of the subsidizing contract.

The insurer‘s share is not affected by mutualisation since the amount paid to the other p/h on behalf of the subsidizing p/h is fully paid from p/h share in the u/is.



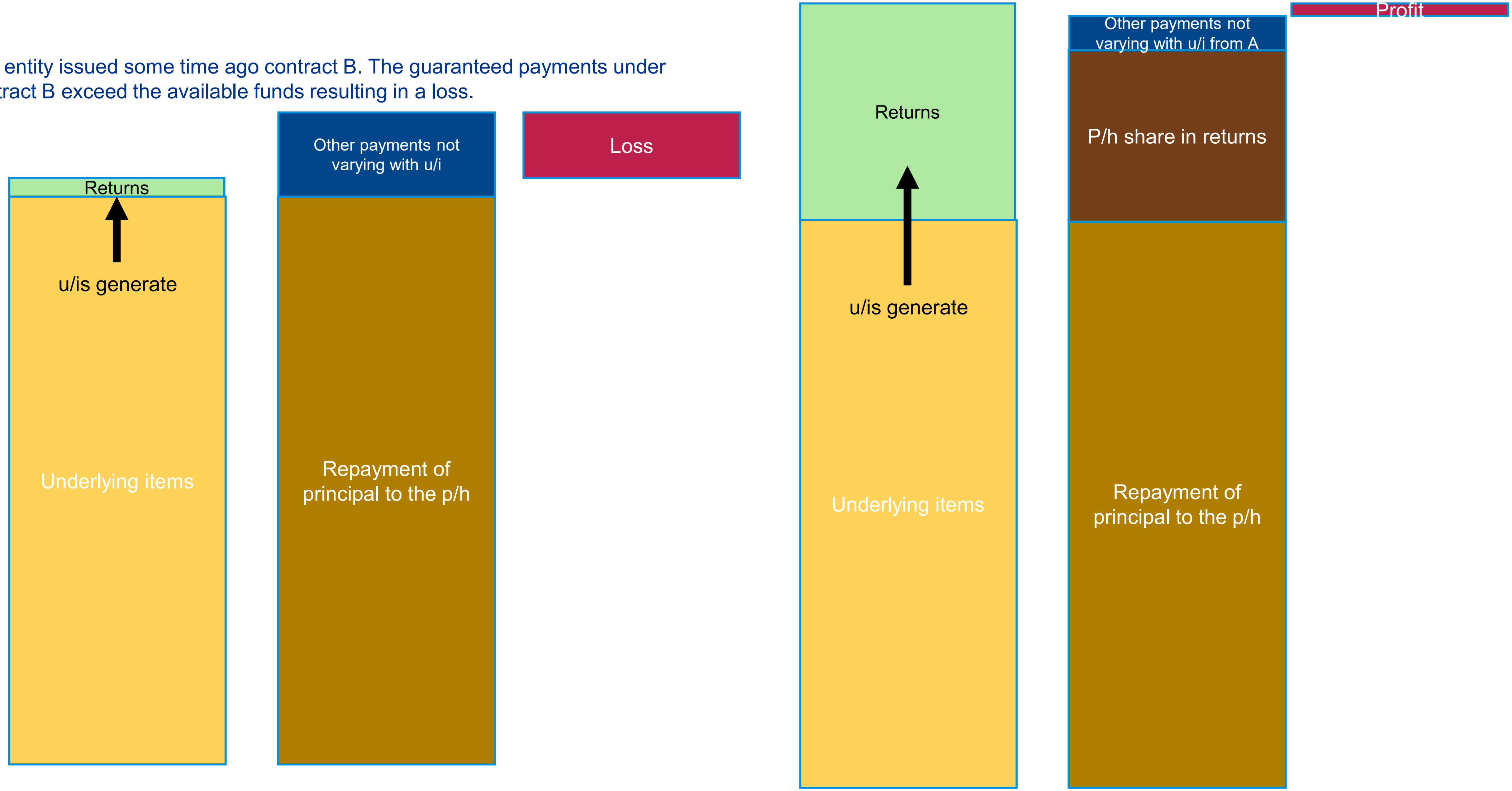
Now the perspective of both contracts together

- Under mutualisation the profit of the subsidizing contract (B in the example before) always remains unchanged since it is from the perspective of that contract just an issue of allocating (inheriting) the contract’s share in the u/is.
- However, in difference to inheriting, the amount is not paid to another contract (A) as additional amount (on top of the obligations existing under that contract) but covers there existing obligations which affects the profit situation of the insurer there advantageously.
- There are three possibilities: The amount taken from contract B is
  - lower than the obligation under contract A, in that case a loss remains under contract A (partial mutualisation).
  - equal to the obligation under contract A, in that case the obligation becomes neutral for the insurer (full mutualisation).
  - higher than the obligation under contract A, in that (very special) case the presence of the obligation under contract A creates even an additional profit for the insurer, i.e. due to that obligation under contract A the insurer is entitled to retain additional amounts from the u/is of contract A while the obligation is covered by contract B.

IFRS 17.B103 New contract A supports existing contract B

The entity issues a contract A with low guarantees expected to produce significant returns. The entity is permitted to reduce the returns to cover non-varying payments under other contracts.

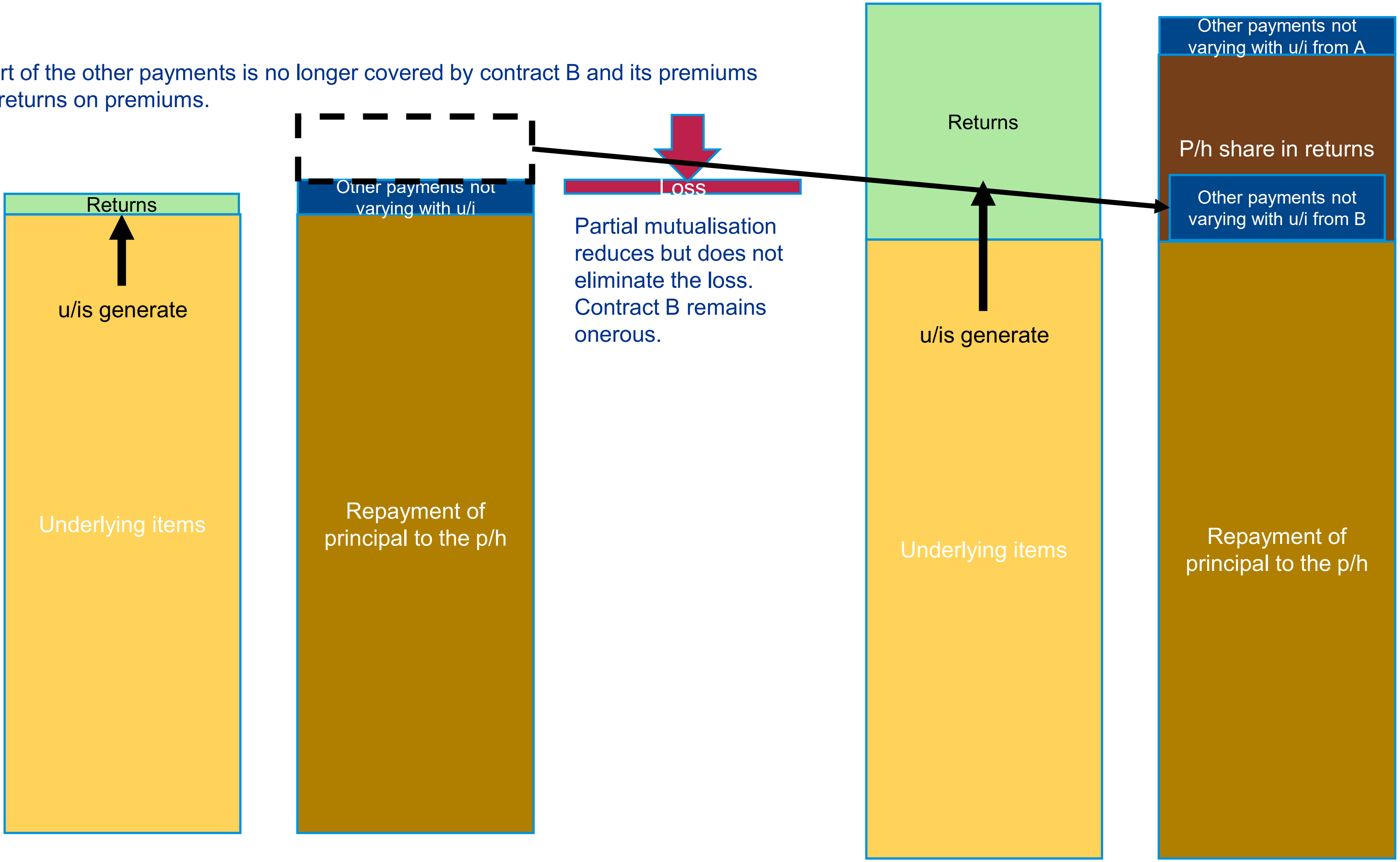
The entity issued some time ago contract B. The guaranteed payments under contract B exceed the available funds resulting in a loss.



IFRS 17.B103 New contract A supports existing contract B

The part of the other payments of contract B is covered by premiums and returns on premiums from contract A. A minor loss remains with contract B, since it is only partial mutualisation (90% formula). The cash flows and profit from contract A are not affected.

A part of the other payments is no longer covered by contract B and its premiums and returns on premiums.



Profit

The profit remains unchanged by mutualisation

In contract A, the payment varies with the u/is of A, since if not covered, it would move back to contract B. The amount may be covered by premiums or returns on premiums of A.

IFRS 17.B101 is applied on that basis, which does not make a difference.

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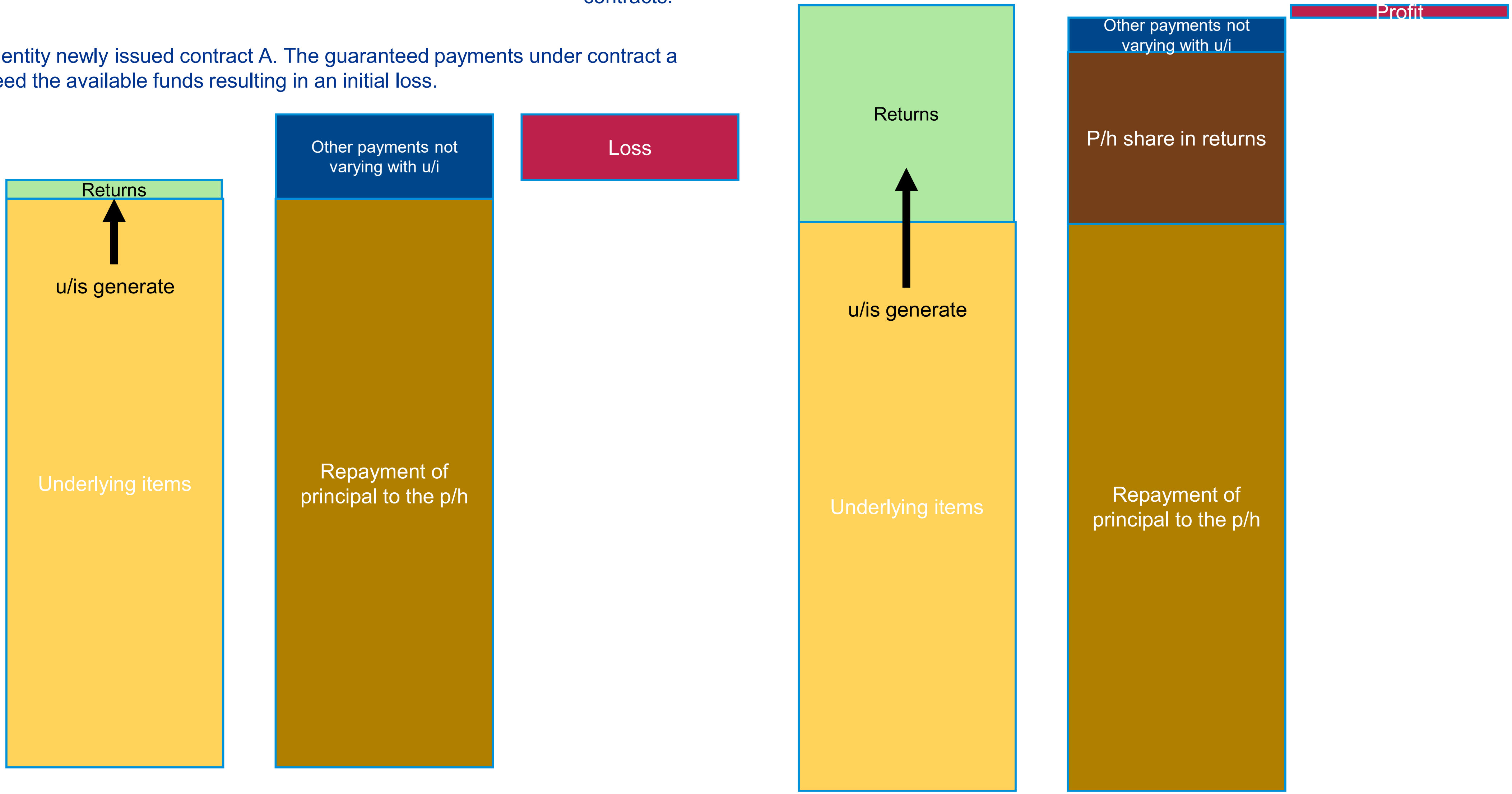
IFRS 17.B103 Existing contract B supports new contract A

The entity issued some time ago a contract B with low guarantees expected to produce significant returns. The entity is permitted to reduce the returns to cover non-varying payments under other contracts.

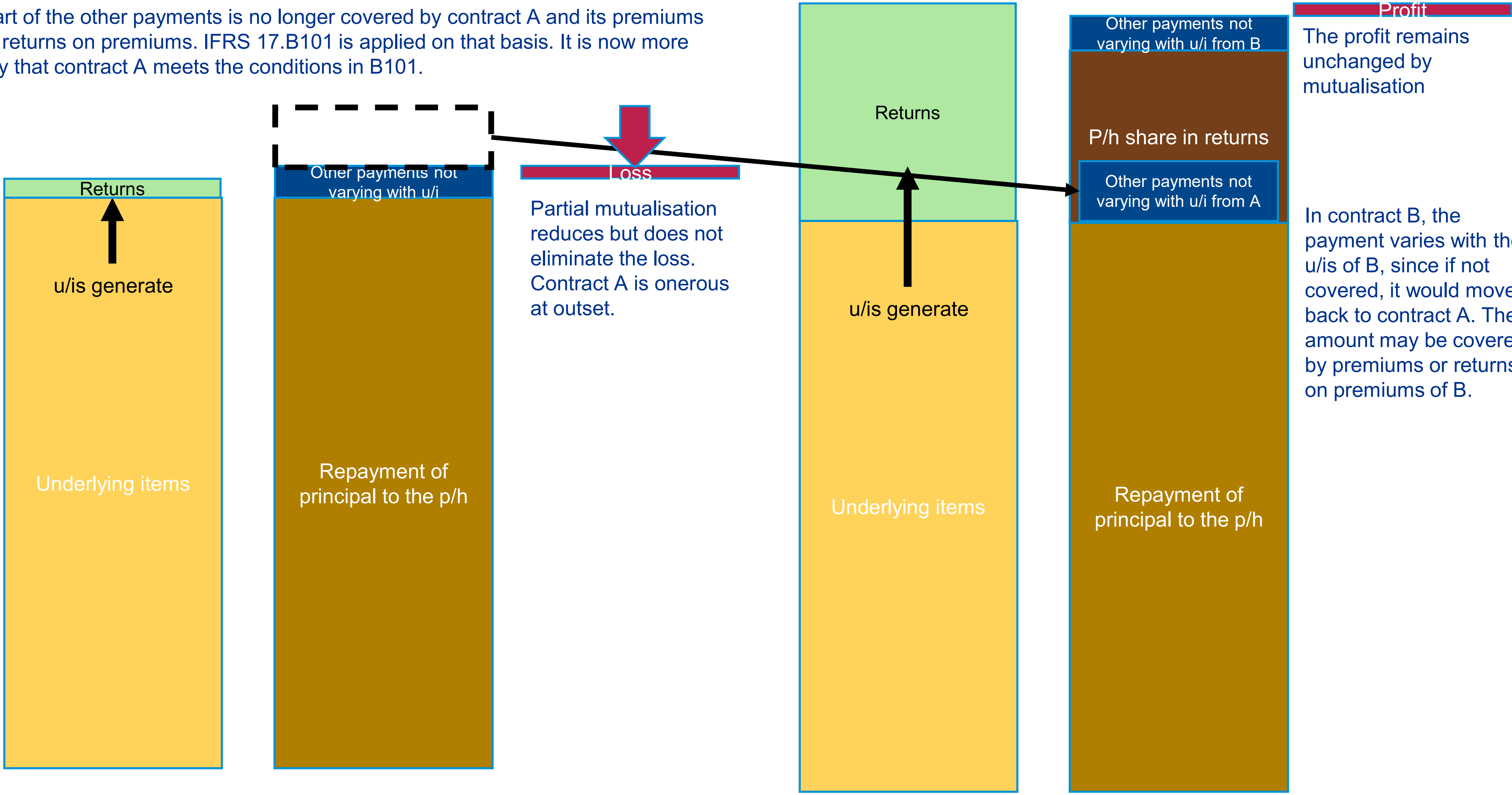
The entity newly issued contract A. The guaranteed payments under contract a exceed the available funds resulting in an initial loss.



IFRS 17.B103 Existing contract B supports new contract A

The part of the other payments of contract A is covered by premiums and returns on premiums from contract B. A minor loss remains with contract A, since it is only partial mutualisation (90% formula). The cash flows and profit from contract B are not affected.

A part of the other payments is no longer covered by contract A and its premiums and returns on premiums. IFRS 17.B101 is applied on that basis. It is now more likely that contract A meets the conditions in B101.



Partial mutualisation reduces but does not eliminate the loss. Contract A is onerous at outset.

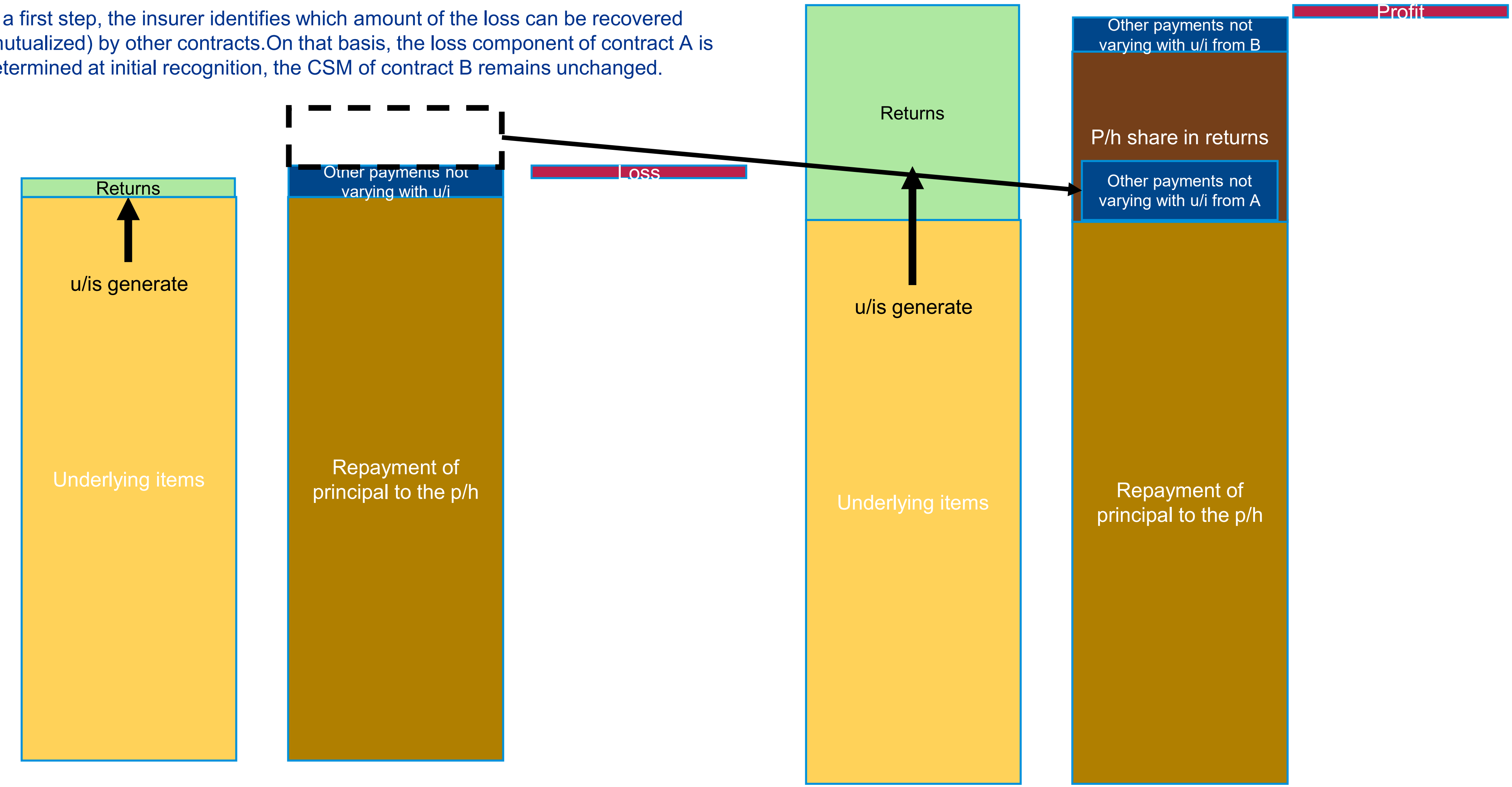
The profit remains unchanged by mutualisation

In contract B, the payment varies with the u/is of B, since if not covered, it would move back to contract A. The amount may be covered by premiums or returns on premiums of B.

IFRS 17.B103 Existing contract B supports new contract A

Practical approach: It is technically normally impractical to proceed as described in the slide before. Therefore following practical approach may be suitable:

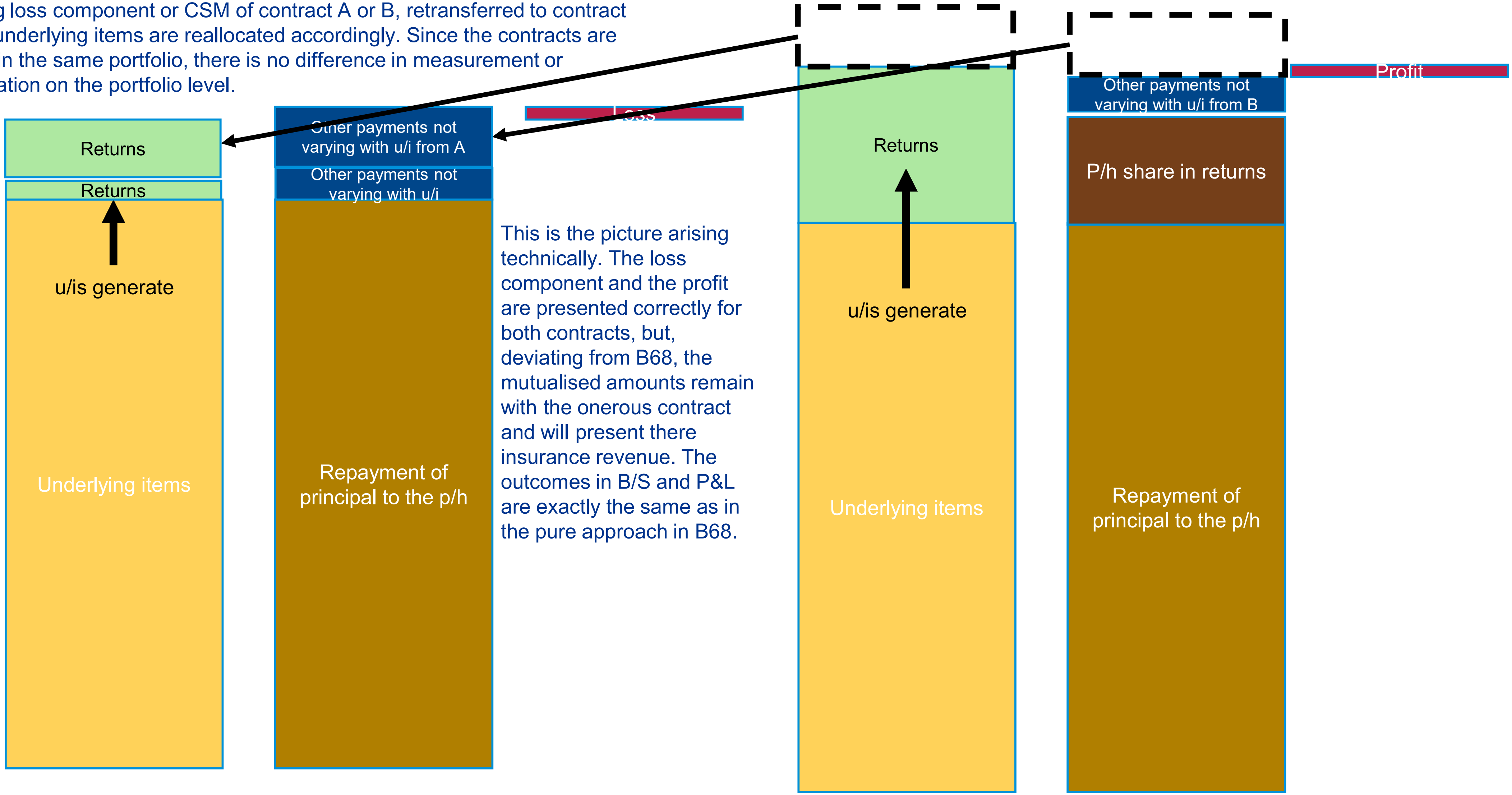
In a first step, the insurer identifies which amount of the loss can be recovered (mutualized) by other contracts.On that basis, the loss component of contract A is determined at initial recognition, the CSM of contract B remains unchanged.



IFRS 17.B103 Existing contract B supports new contract A

Practical approach: It is technically normally impractical to proceed as described in the slide before. Therefore following practical approach may be suitable:

For technical reasons, the amount transferred to contract B is, without affecting loss component or CSM of contract A or B, retransferred to contract A. The underlying items are reallocated accordingly. Since the contracts are usually in the same portfolio, there is no difference in measurement or presentation on the portfolio level.



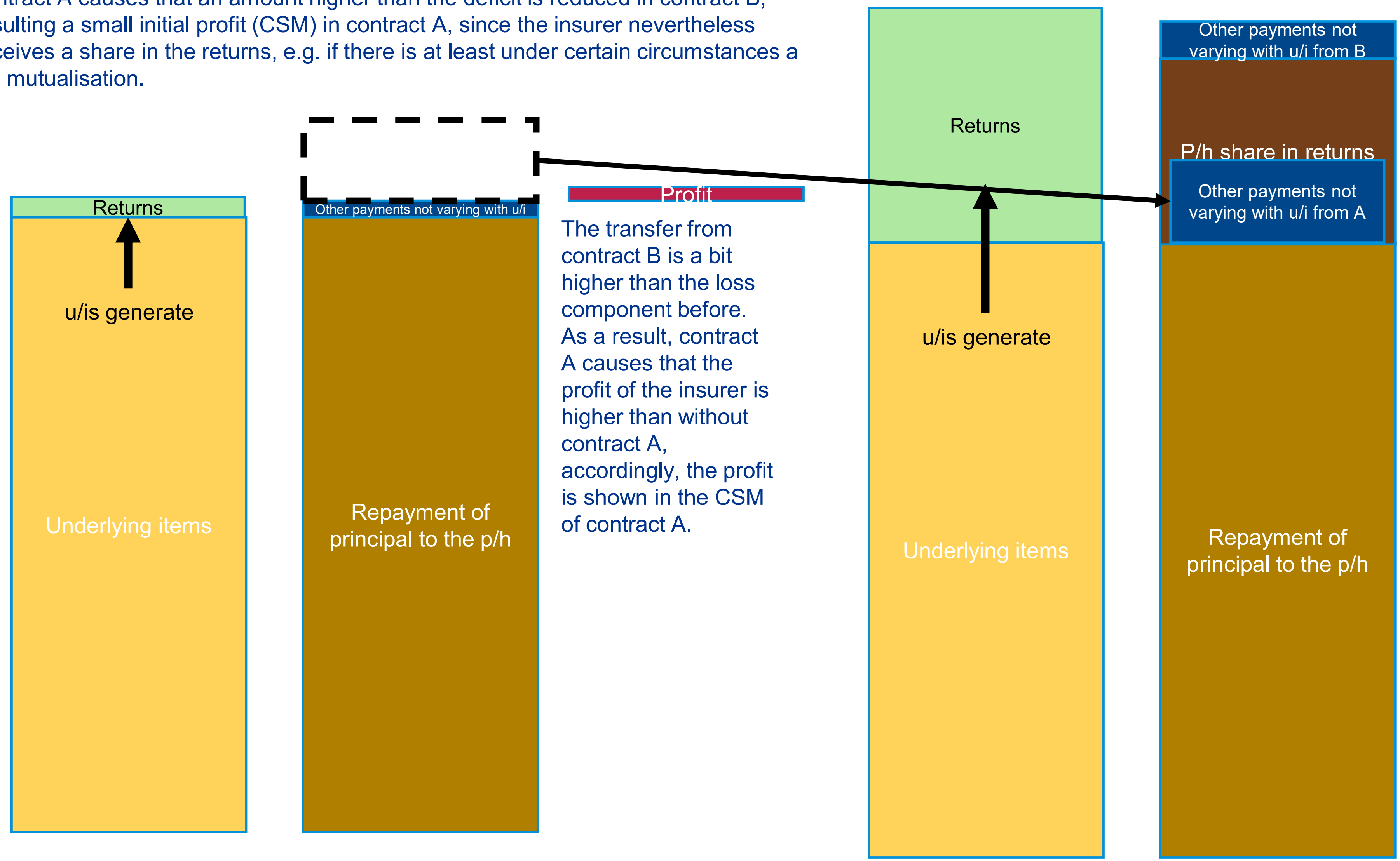
This is the picture arising technically. The loss component and the profit are presented correctly for both contracts, but, deviating from B68, the mutualised amounts remain with the onerous contract and will present there insurance revenue. The outcomes in B/S and P&L are exactly the same as in the pure approach in B68.

Example: Onerous contract increases profit

- Participation rule: Insurer retains 10% of collective investment returns, as long as the guarantees can be collectively paid by the policyholders' 90%.
- Entity earns 2% interest
- Large existing business has a guarantee of 1%, volume 100,000 €.
- Entity issues a contract with 1,000 € single premium and a minimum interest guarantee of 3% for 1 year. Isolated, the contract has a loss of 20 € initially.
- Overall, the entity earns instead of 2,000 investment returns 2,020 € investment returns. Due to the new contract, it can retain 202 € instead of only 200 €. As a result, the new contract has an initial CSM of 2 €.

IFRS 17.B103 Existing contract B supports new contract A

Under very special participation rules it may be even possible that the deficit in contract A causes that an amount higher than the deficit is reduced in contract B, resulting a small initial profit (CSM) in contract A, since the insurer nevertheless receives a share in the returns, e.g. if there is at least under certain circumstances a full mutualisation.



The transfer from contract B is a bit higher than the loss component before. As a result, contract A causes that the profit of the insurer is higher than without contract A, accordingly, the profit is shown in the CSM of contract A.

The profit remains unchanged by mutualisation

In contract B, the payment varies with the u/is of B, since if not covered, it would move back to contract A. The amount may be covered by premiums or returns on premiums of B.

Conclusion

- Mutualisation (IFRS 17.B67) refers to the case where the entity is contractually permitted (i.e. fulfilling its obligations to that p/h) to use the p/h's share in the fair value of the u/is of one contract (i.e. payments varying with the fair value of the u/is) to provide payments to another p/h which do not vary with the u/is of that other p/h.

- That means, the insurer is obliged to pay to p/h A CU 100 in excess of the u/is related to p/h A. Further, the insurer is obliged to pay to p/h B at least CU 200 as share of the u/is related to p/h B. The case in B68 refers to a contractual right of the insurer, if and only if p/h A is in that situation, to fulfil the obligation to pay the CU 150 to p/h B by paying the CU 100 to p/h A and pay only CU 50 to p/h B, i.e. the insurer is able to meet with paying the same CU 100 two obligations since the obligation to p/h B is subsidiary.

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IFRS 17.B101: The VFA-criteria

IFRS 17.A

Insurance contract with direct participation features

An **insurance contract** for which, at inception:

(a) the contractual terms specify that the **policyholder** participates in a share of a clearly identified pool of **underlying items**;

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

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

What is the meaning of IFRS 17.B101 Sentence 1?

- IFRS 17.B101 sentence 1: “Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items.”
- The sentence is not included in the definition of insurance contract with direct participation features in IFRS 17.A.
- **The sentence does not appear to include any condition for qualifying as VFA-contract, since the next sentence continues:**
- “Hence, they are defined as insurance contracts for which:” **[followed by the criteria found as well in IFRS 17.A.]**
- **The sentence is seen to be a motivation to explain a typical character of such contracts, which meet the criteria in IFRS 17.B101(a) to (c). The fact that a contract which meets those criteria but might not be seen as “substantially investment-related” does not disqualify it as VFA-contract.**

What is the meaning of IFRS 17.B101(a)?

- IFRS 17.B101(a): “the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items”
- **The legal terms of the contract need to determine**
  - a clearly identifiable pool of u/is
    - They do not need to be explicitly noted in the contract but the contract and legal guidance need to enable a clear identification of the u/is (e.g. by referring to the returns from items, which identifies as well the items).
  - a certain share of the p/h in the u/is
    - The share does not need to the expected share referred to in IFRS 17.B101(b) and (c). It does not need to be defined as a fixed percentage, any form of formula is permitted.

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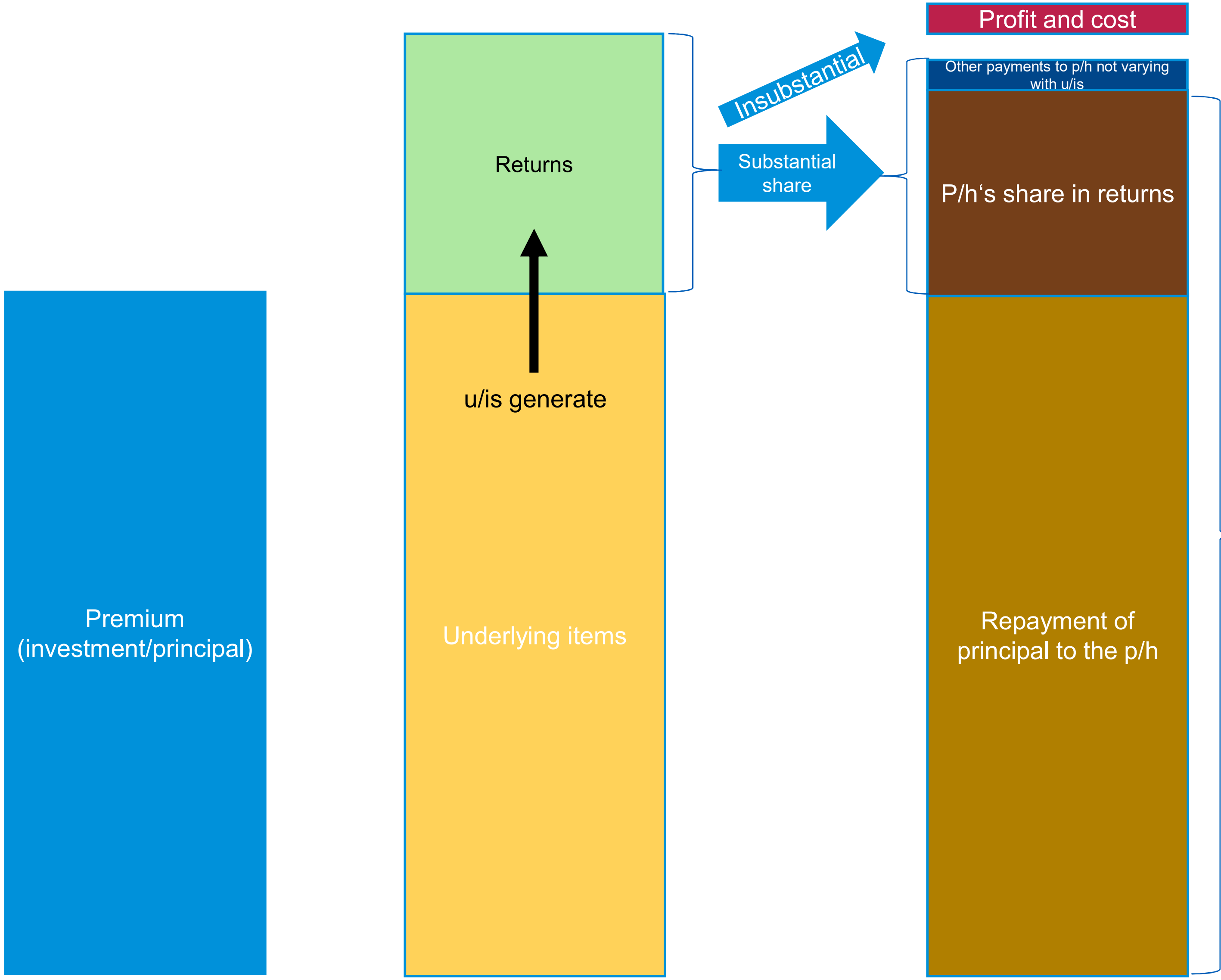
What is the meaning of IFRS 17.B101(b)?

- IFRS 17.B101(b): “the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items”
- **The expected value of the payments to the p/h in excess of the repayment of the principal is a substantial share of the expected fair value returns on the u/is.**
- **Note: The “expects” is not an accounting term – i.e. it refers to the realistic expectations of the entity, not to amounts considered in measurement. That particularly means that the “fair value returns on the underlying items” are real world returns, not risk-free returns.**
  - However, if the entity is able to show that IFRS 17.B101(b) is met for risk-free returns, that should apply as well for real world returns.

IFRS 17.B101(b)

„Other payments not varying with u/is“ refers to payments under the investment-related services, e.g. minimum guaranteed benefits, cost of providing the services etc. or other services financed from insurer‘s share, i.e. if the cash flows do not incur, the amounts belong to the insurer, i.e. are amounts on insurer‘s risk.

Expected present values at outset



Includes the excess of minimum payments beyond the u/is, but only payments to the p/h or other p/hs

„Payment“ refers to a transfer of ressources to this or another p/h, i.e. „benefits“. That includes benefits in kind (B65(g)), off-setting of otherwise payable premiums or in lieu of premiums otherwise needed to finance the increase of future rights of the p/h caused by the „payment“.

Relevant is that this amount is deducted from the u/is and accordingly fulfills the obligation to pay the u/is to p/hs, and if the amount does not incur, it continues to belong to the p/hs, i.e. the amounts are on p/h‘s risk. They are of the type „inheritance“ or „mutualisation“.

What is the meaning of IFRS 17.B101(b)?

- IFRS 17.B101(b): “the entity expects to pay to the policyholder an amount equal to a **substantial** share of the fair value returns on the underlying items”
- When is a share “substantial”?
  - “substantial” = “in substance”
  - Substance is the main part, i.e. a substantial share cannot be less than 50%.
  - An IASB member referred in the respective meeting to “80%”, which could be seen as an “ideal” threshold.
  - In practice, auditors do not accept less than 50%.
- P/h’s total share over the entire contract duration must not be, on an end value basis, less than 50% of the total returns on u/is in that time.

Explanation

Examples for other payments to p/h:

- Excess minimum guaranteed benefits not covered by u/is and not covered via mutualisation, e.g.
  - Minimum guaranteed maturity values (based on minimum guarateed interest)
  - Minimum death benefits
  - Minimum surrender values

Explanation

Examples for other payments not paid to p/h:

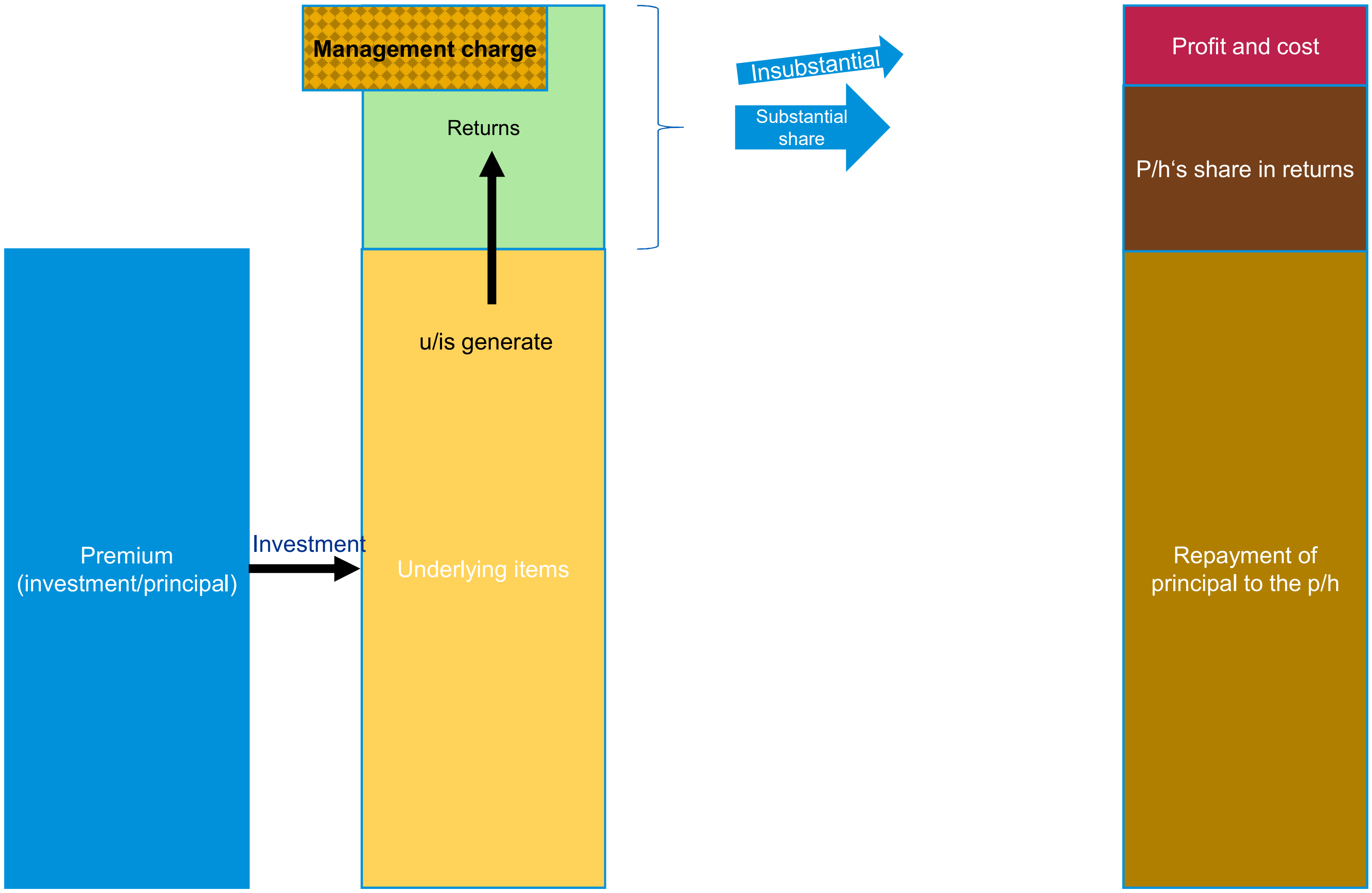
- Cost of providing investment-related services
- Related overhead cost
- Related IACF
- Cost (or parts of cost) acquiring other services to p/hs, whose variation is entirely at the risk of the insurer.

- All amounts not paid to p/hs count as insurer‘s share except if they are charged for providing other services (e.g. mortality coverage) and as far as they are paid out of the u/is.

Timing of charging cost

- The timing of cost changes the ability to generate returns. That shall be considered in applying IFRS 17.B101(b).
- Example: If a management charge is made directly at outset by reducing premiums to be invested in the u/is,
  - it is nevertheless assumed that the full premium is invested in the u/is
  - but u/is are withdrawn immediately to the benefit of the insurer and
  - returns are calculated on the charge until termination of the contract and
  - included in the comparison of returns and and p/h‘s share.

IFRS 17.B101(b) Terminal charges unit-linked



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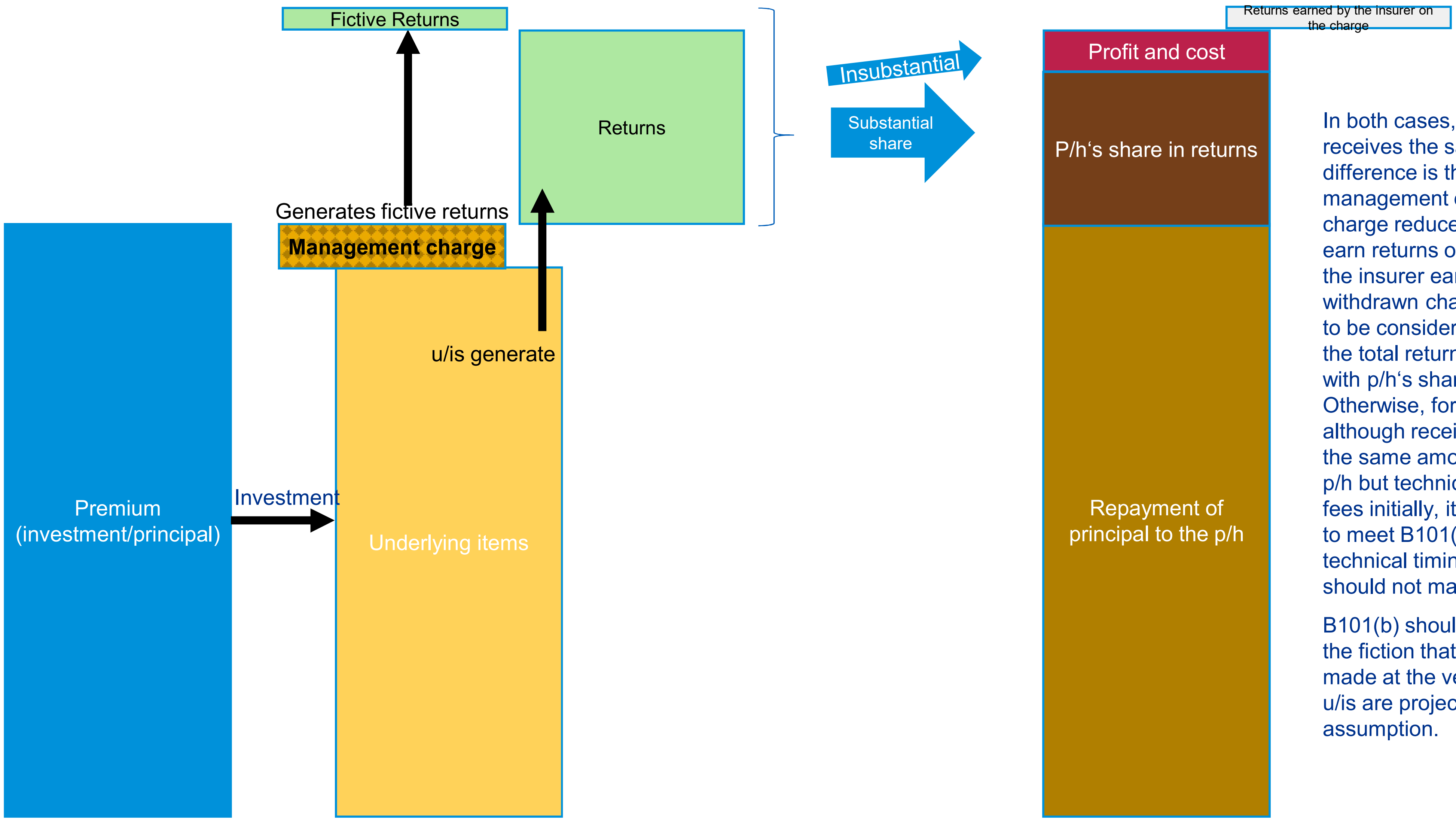
IFRS 17.B101(b) Initial charges unit-linked



In both cases, the p/h pays and receives the same amount. The difference is the timing of the management charge. An initial charge reduces the ability to earn returns on the u/is while the insurer earns returns on the withdrawn charge. That needs to be considered in detemining the total returns in comparison with p/h's share.
Otherwise, for an insurer, although receiving and paying the same amounts from/to the p/h but technically charging its fees initially, it would be easier to meet B101(b). But the technical timing of the charge should not matter.

B101(b) should be applied with the fiction that all charges are made at the very end and the u/is are projected with this assumption.

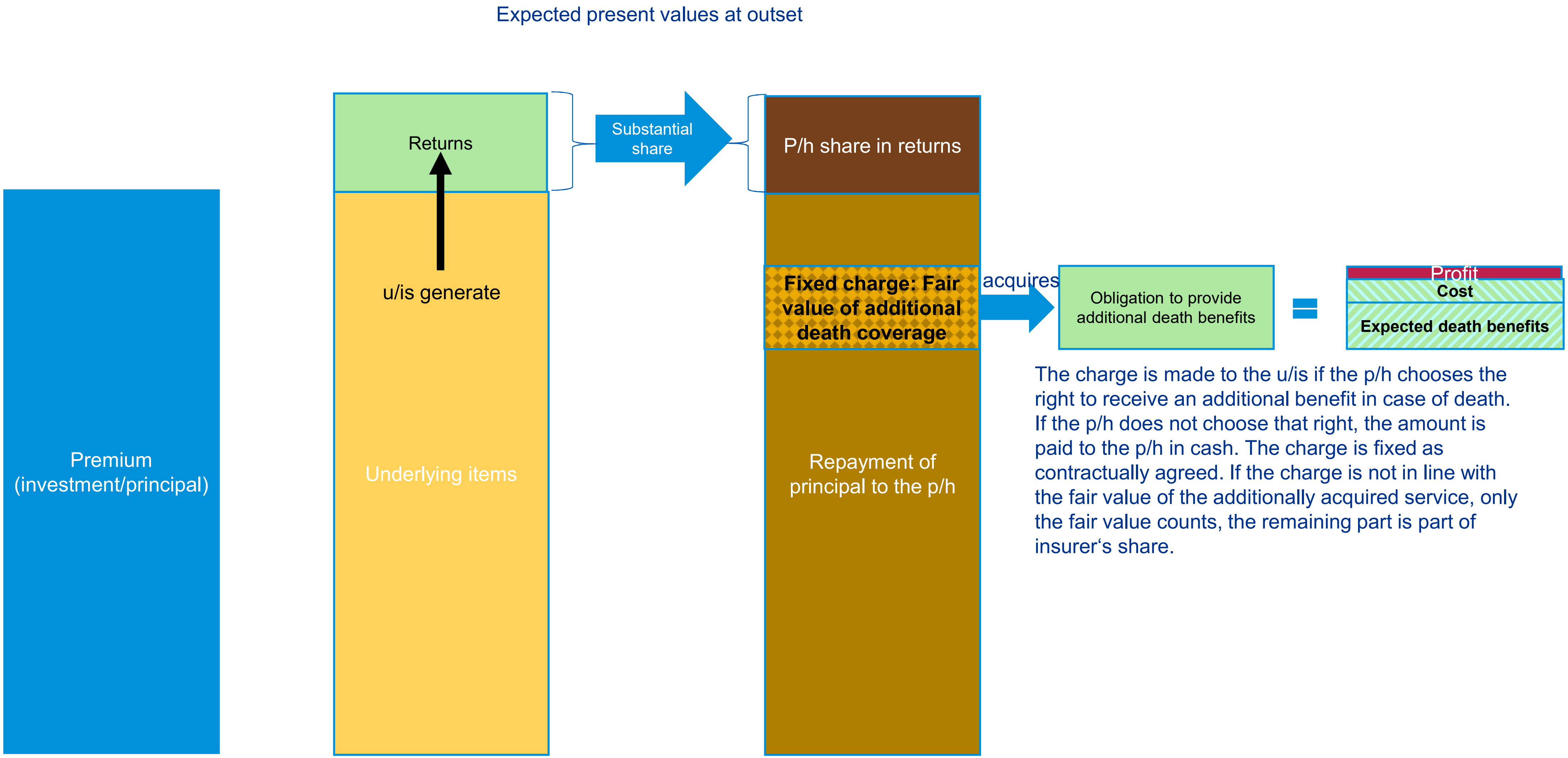
Conclusion

- In applying IFRS 17.B101(b), it should be assumed that all charges are made at the very end and that the returns on the u/is are fictively determined on that basis.

Charges acquiring additional services: TRG S115

- The words „cash flows“ and „payments“ in IFRS 17 do not refer only to an immediate transfer of cash. It refers to any form of transfer of an asset (or a negative liability), particularly are well to cash-equivalents.
- Participating contracts are often a type of deposit from which the consideration for other services are withdrawn acquiring an adequate right (asset) of the p/h.
- Such charges, which acquire an explicit additional right, count as well as payment to the p/h, as long as the charge is adequate.
- It does not matter, how the charge is labelled, relevant is only its economic effect.
  - A charge labelled as mortality charge but higher than a fair price for the acquired mortality, counts beyond the fair price as payment to the insurer.
  - A charge labelled as general charge which includes the remuneration for additional death benefits, counts in the fair value of the death benefit as payment to the p/h.
- That applies as well if not a charge but the actual death benefit (and related cost) is taken from the u/is, even if there is a certain impact on insurer’s share, as long the total is adequate for the service provided.

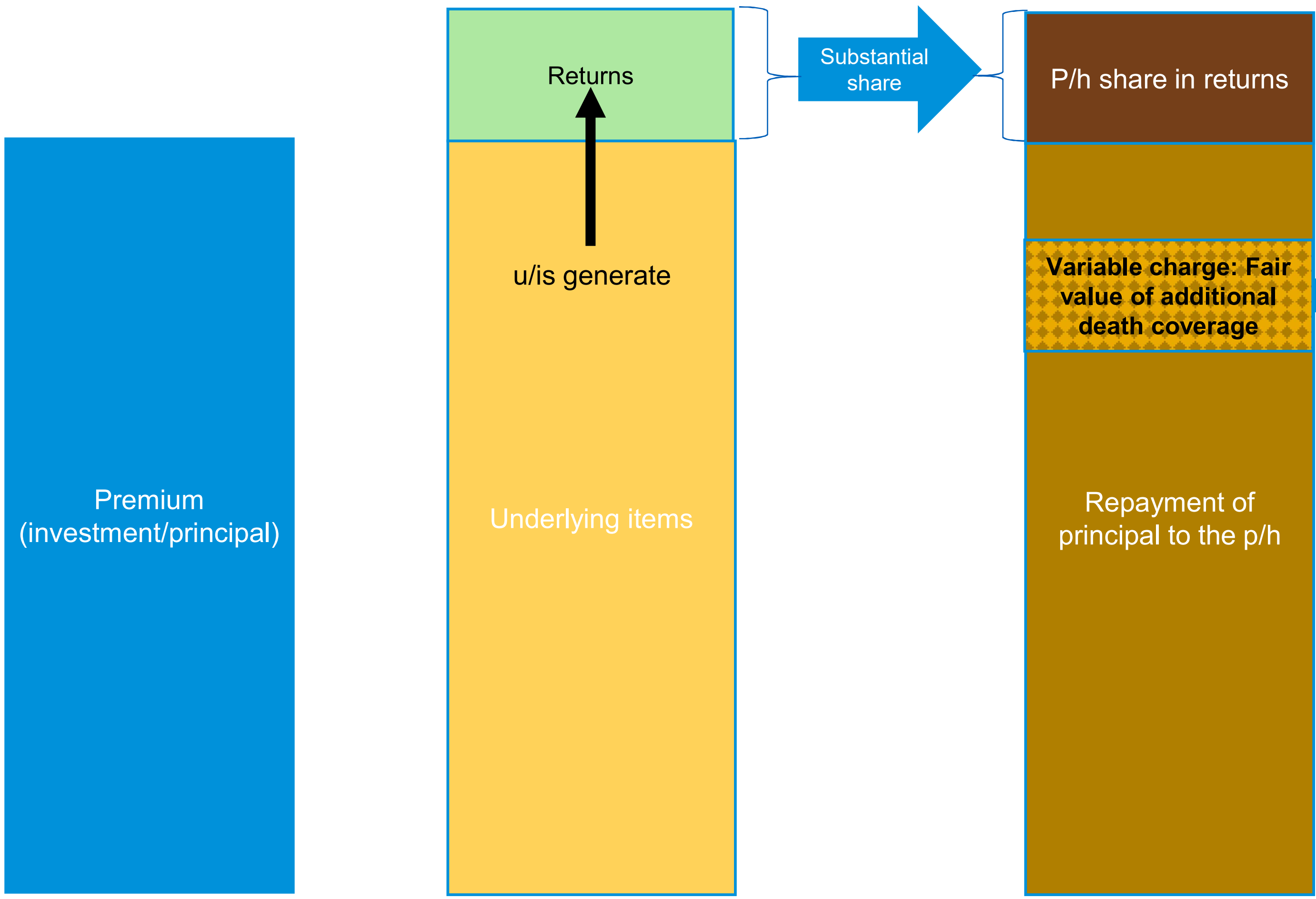
IFRS 17.B101(b) UK unit-linked with death benefit: TRG S115

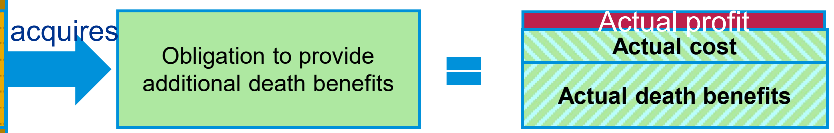


The charge is made to the u/is if the p/h chooses the right to receive an additional benefit in case of death. If the p/h does not choose that right, the amount is paid to the p/h in cash. The charge is fixed as contractually agreed. If the charge is not in line with the fair value of the additionally acquired service, only the fair value counts, the remaining part is part of insurer‘s share.

IFRS 17.B101(b) German traditional endowment: TRG S115

Expected present values at outset





The charge is made if the p/h chooses the right to receive an additional benefit in case of death. If the p/h does not choose that right, the amount is paid to the p/h in cash.

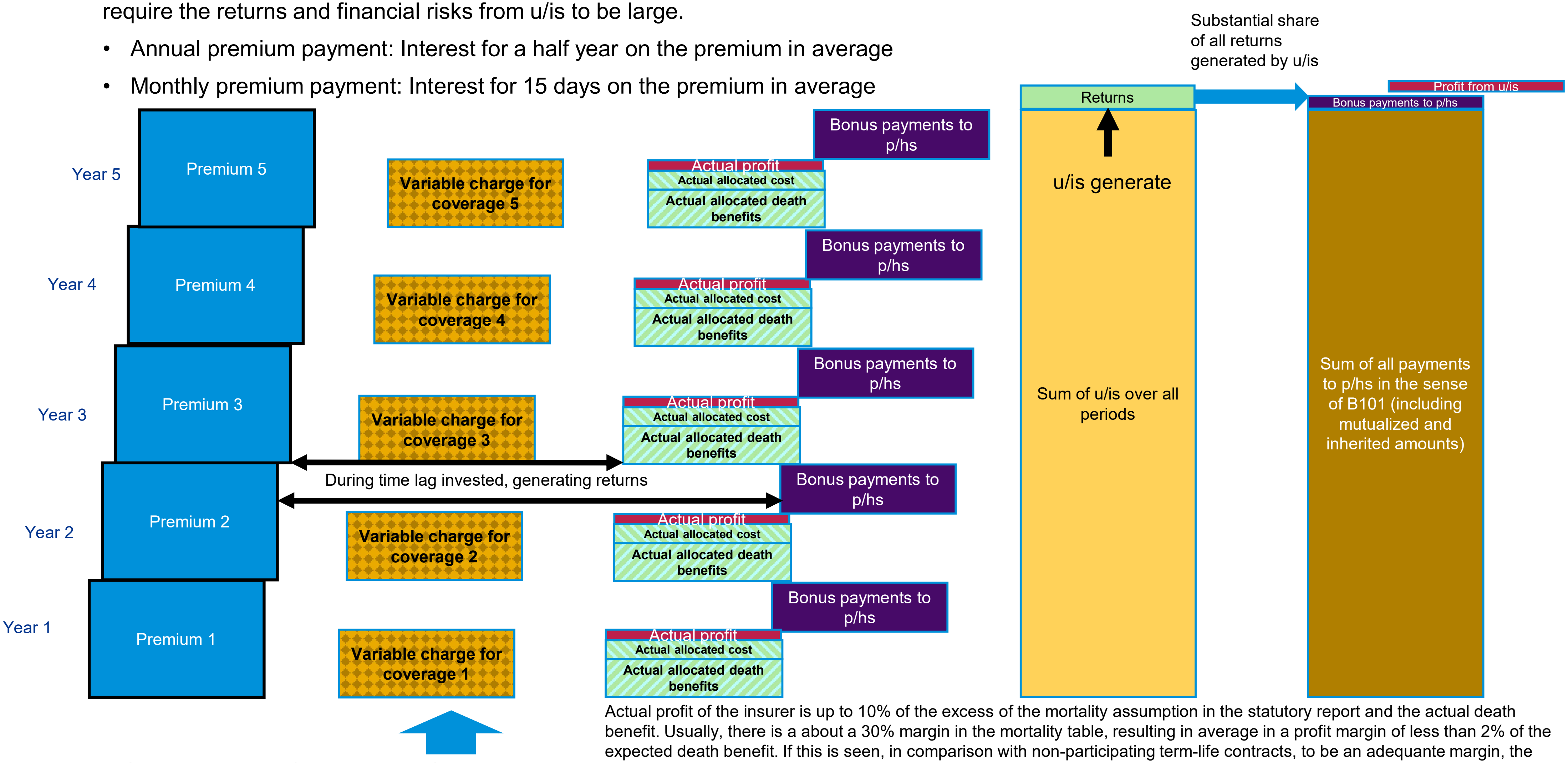
The charge is made in the amount of the actually incurred death benefits and actual cost of the portfolio, as contractually allocated to the contract, plus a reasonable profit margin, i.e. the risk is born (up to the profit margin) by the p/h.

If the p/h dies, the death benefit is actually not paid by the insurer but by means of mutualisation by all other contracts (their rights are reduced) – however it is not always a full mutualisation, since there might be a minor impact to the profit, which is variable based on the actually incurred mortality.

German Participating Term Life Insurance - TRG S115

Regular (annual) premium participating term life insurance of 5 year duration. The same participation rules apply as for all other German participating life insurance contracts, including 90% share of p/hs in any investment return. Any otherwise payable maturity value is absorbed for charges providing coverage. The principles found before are applied consistently. That results in qualifying German participating term life insurance as VFA, since financial risks from underlying items (which are quite small) are substantially forwarded to p/hs. IFRS 17 does not require the returns and financial risks from u/is to be large.

- Annual premium payment: Interest for a half year on the premium in average
- Monthly premium payment: Interest for 15 days on the premium in average



Count as payment to p/hs in applying IFRS 17.B101.

Actual profit of the insurer is up to 10% of the excess of the mortality assumption in the statutory report and the actual death benefit. Usually, there is a about a 30% margin in the mortality table, resulting in average in a profit margin of less than 2% of the expected death benefit. If this is seen, in comparison with non-participating term-life contracts, to be an adequante margin, the contract here is VFA. .

Comment

- IFRS 17.B104 assumes that there is an obligation to pay to the p/h (or another p/h) an amount equal to the u/is.
- That payment can be made in cash or in form of any transfer of an asset.
- TRG S115 assumes therefore, that a charge deducted from the u/is (otherwise payable in cash to the p/h) for the transfer of additional services beyond investment-related services to the p/h is equivalent to a payment to the p/h, i.e. including any profit and compensation for cost typically required for providing those services.
- It cannot matter, how much from the u/is actually remains for cash payment and how large the returns on the u/is may be due to early repayment. Assume, that the entity would not charge for coverage, but would at the same time pay the charge in cash to the p/h. The returns would be equally low.
- Example: Education protection plan to pay university fee plus living
  A father pays an annual premium of 100 on 1 January as long as he lives, maximum for 5 years. The insurer pays at next 1 February to the child at least 100, but typically pays 100.14 (u/is are expected to generate 2% p.a.). In the case of death of the father, the benefit is nevertheless continued, for a charge of 0.02 deducted from every premium paid. As well here the returns are very small, 0.83 compared with 500 premium, since any amount paid in is repaid after a month plus a part of the interest earned in that time, but B101(b) is met.

Conclusion

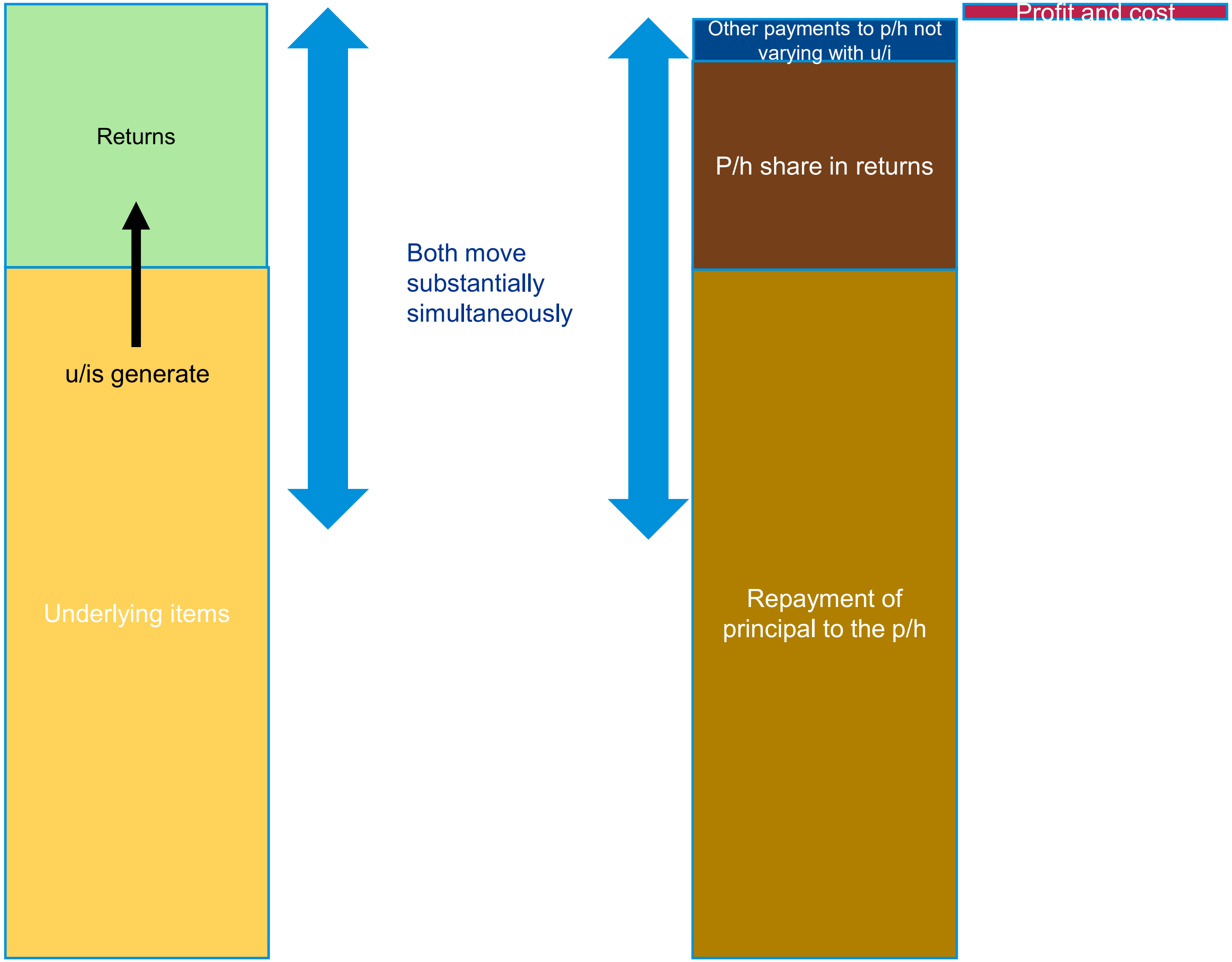
- Applying IFRS 17.B101(b) expected charges acquiring additional services reducing the u/is otherwise payable to the p/h are considered to be payments to the p/h if they are broadly at market prices for the additional services.
- Expected variable charges, depending on the amount of cost of service but including as well charges for profit and cost as a fixed charge, for additional services where the benefits are covered by at least partial mutualisation are considered as well that way.
- All other charges expected to be made are considered as not being paid to the p/h.

What is the meaning of IFRS 17.B101(c)?

- IFRS 17.B101(c): “the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items”

IFRS 17.B101(c) Expected scenario

Expected present values of the variations at outset



Expected present values of the variations at outset

Both amounts vary simultaneously:

- in substantially all scenarios
- at the substantially same amount

If in scenarios of a substantial probability one varies but the other not or not similarly, the condition is not met.

A very good correspondence in some scenarios can heal a lesser correspondence in other scenarios, as long as probability-weigted the average is substantial correspondence.

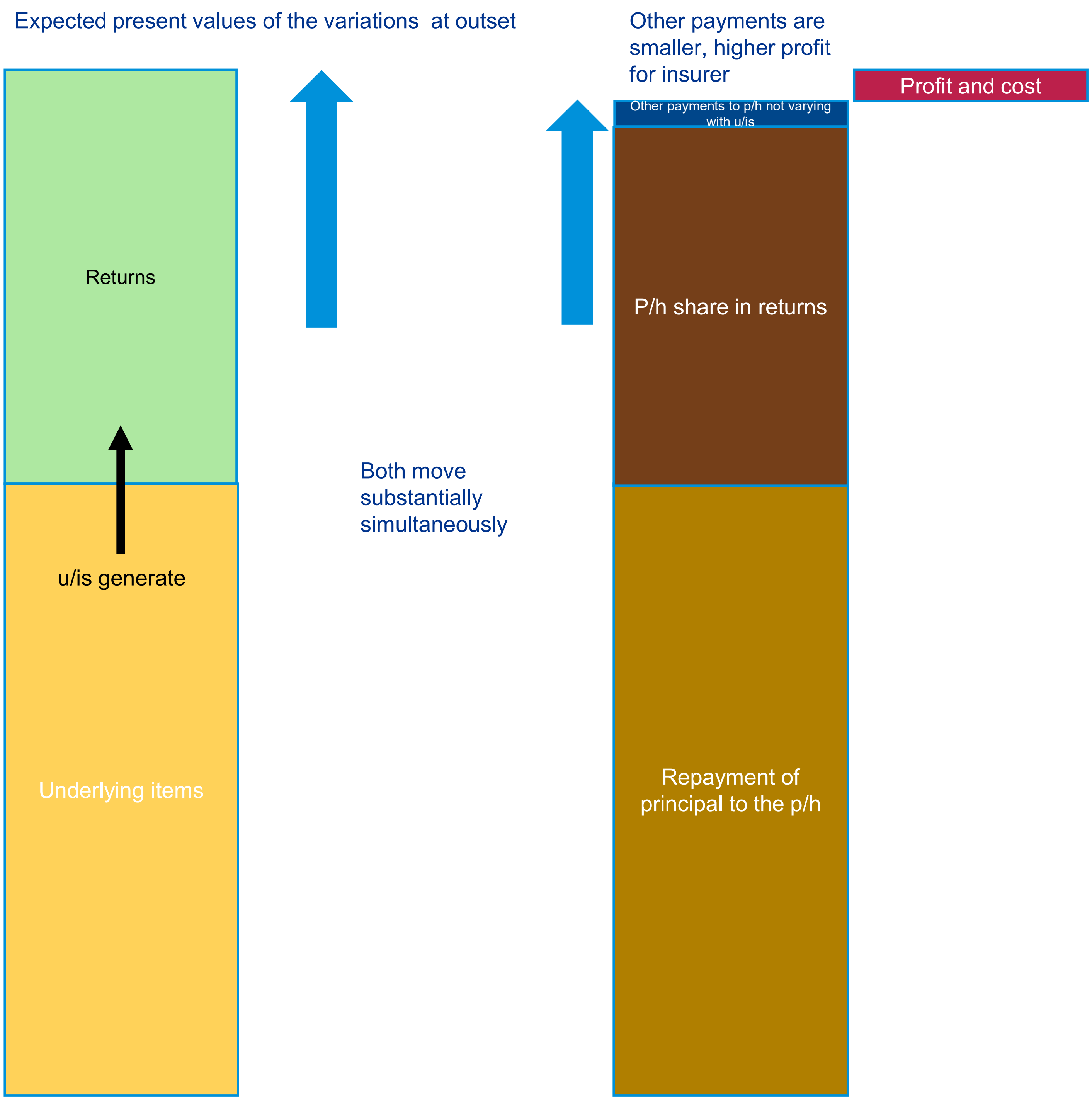
Other payments not varying with u/is are often negatively correlated, i.e. increase when returns decrease, increase when returns decrease.

IFRS 17.B101(c) Advantageous

Expected present values of the variations at outset

Both amounts vary simultaneously:

- in substantially all scenarios
- at the substantially same amount



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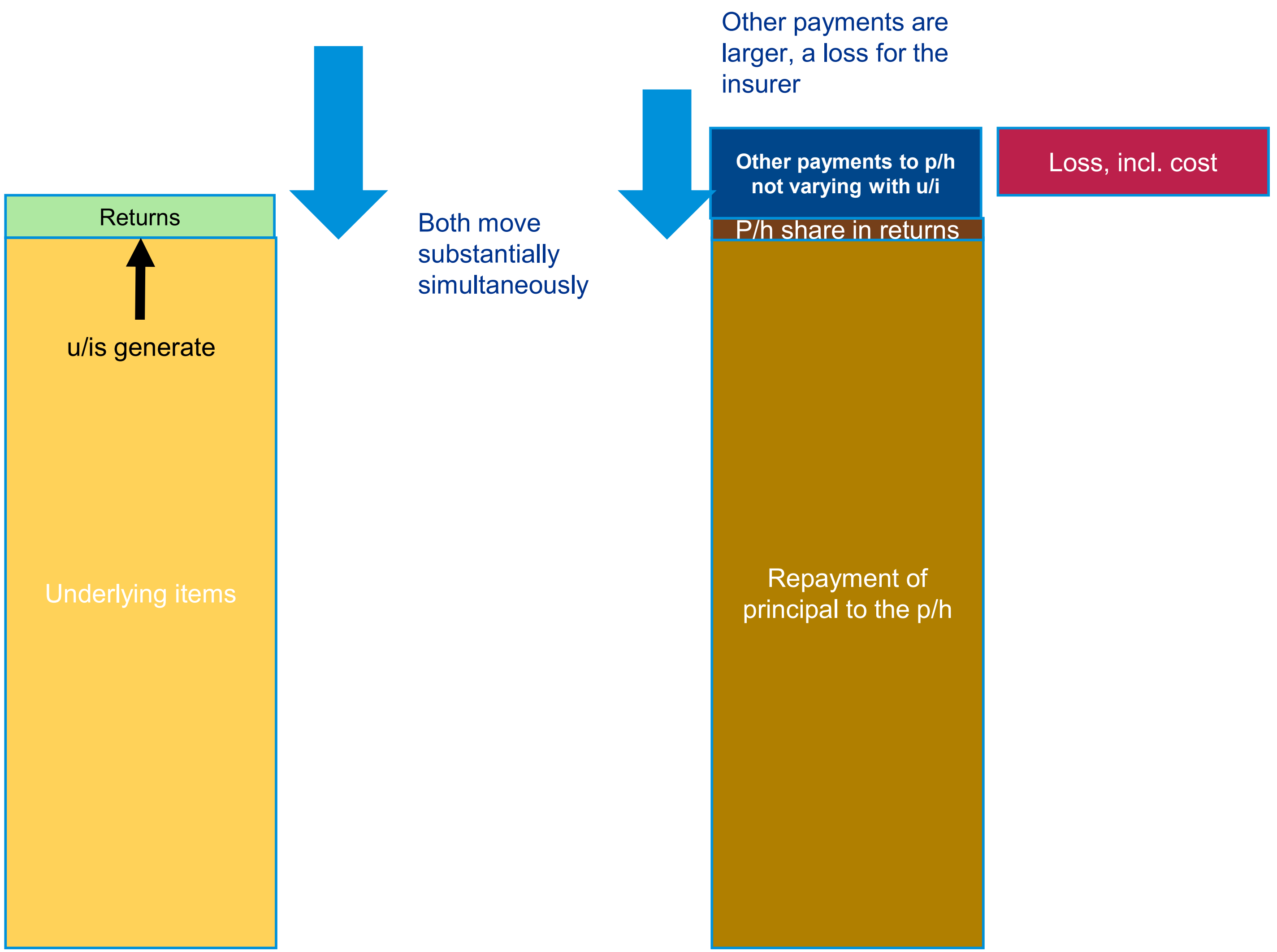
IFRS 17.B101(c) Disadventageous

Expected present values of the variations at outset

Expected present values of the variations at outset

Both amounts vary simultaneously:

- in substantially all scenarios
- at the substantially same amount



IFRS 17.B101(c) Advantageous

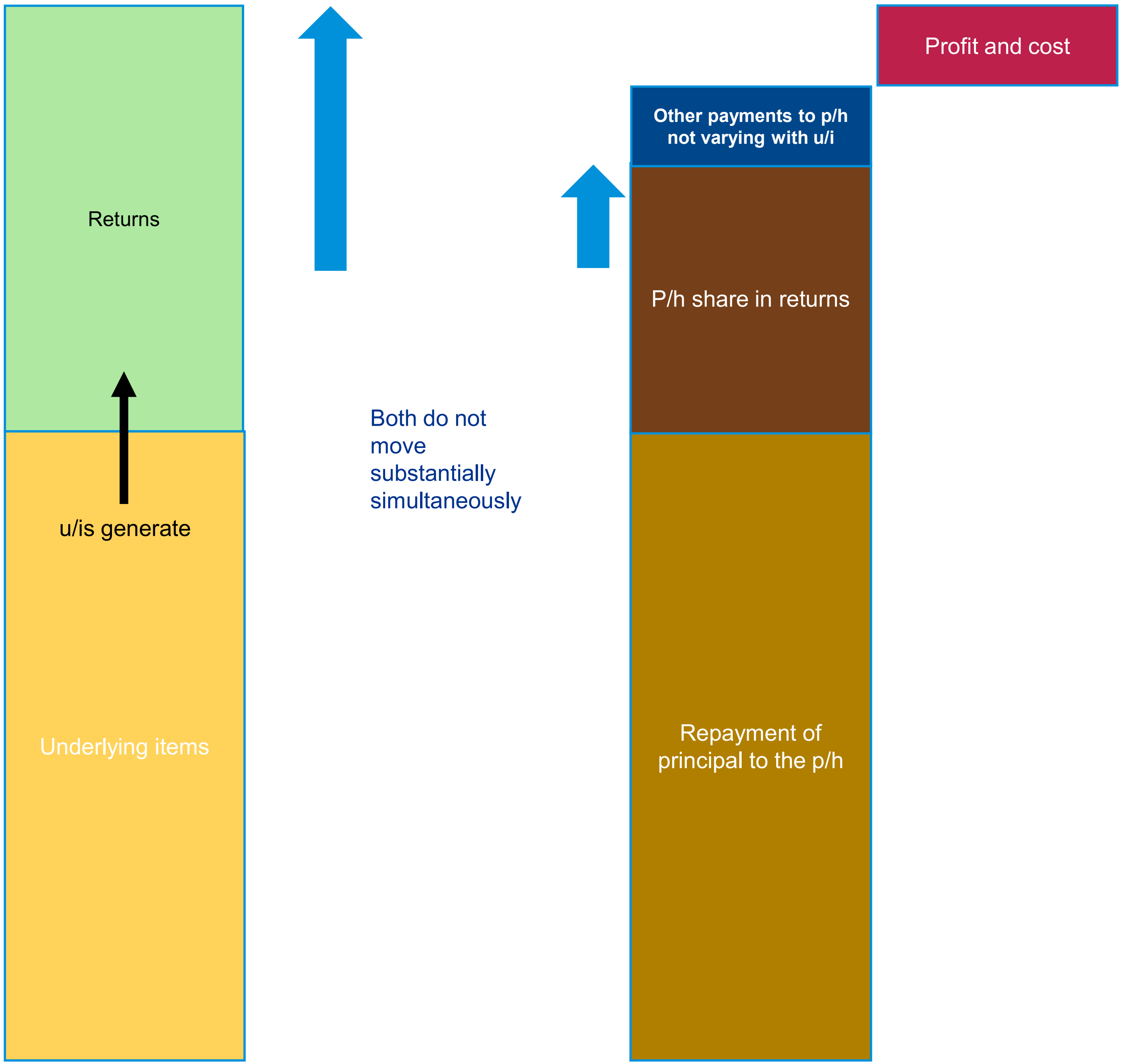
Expected present values of the variations at outset

Both amounts vary simultaneously:

- substantially in all scenarios
- substantially at the same amount

In this scenario, the severe share of the insurer in the higher returns reduces the simultaneity substantially.

Expected present values of the variations at outset



IFRS 17.B101(c) Disadvantageous

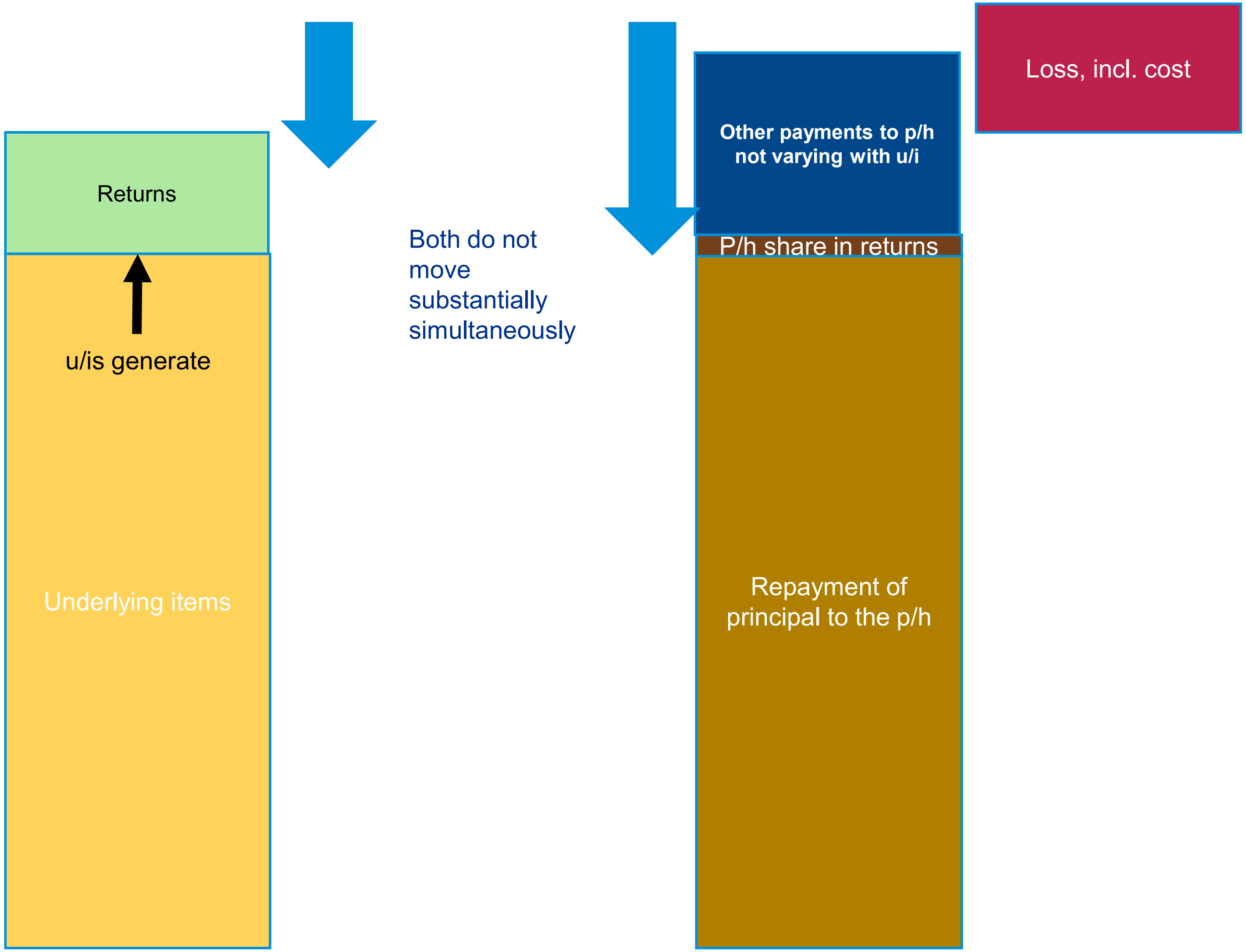
Expected present values of the variations at outset

Both amounts vary simultaneously:

- substantially in all scenarios
- substantially at the same amount

In this scenario, the reduction in returns does not correspond properly with the change in the payments to the policyholder (other than those caused by voluntary payments by the insurer) since the guaranteed payments cannot be reduced. In difference to IFRS 17.B101(b), paying more to the policyholder does not improve the compliance with IFRS 17.B101(c) since here the movements shall be simultaneous, in advantageous and disadvantageous scenarios.

Expected present values of the variations at outset



Conclusion

- IFRS 17.B101(c) is met if both amounts vary simultaneously, i.e.
  - substantially in all scenarios
  - substantially at the same amount
- A possible approach to present the simultaneous moves in normal situations is by calibrated covariances, e.g. the Pearson correlation coefficient.
- The movement is substantially simultaneous, if simultaneity is predominant.

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IFRS 17.B101(b) and (c): Unit-linked

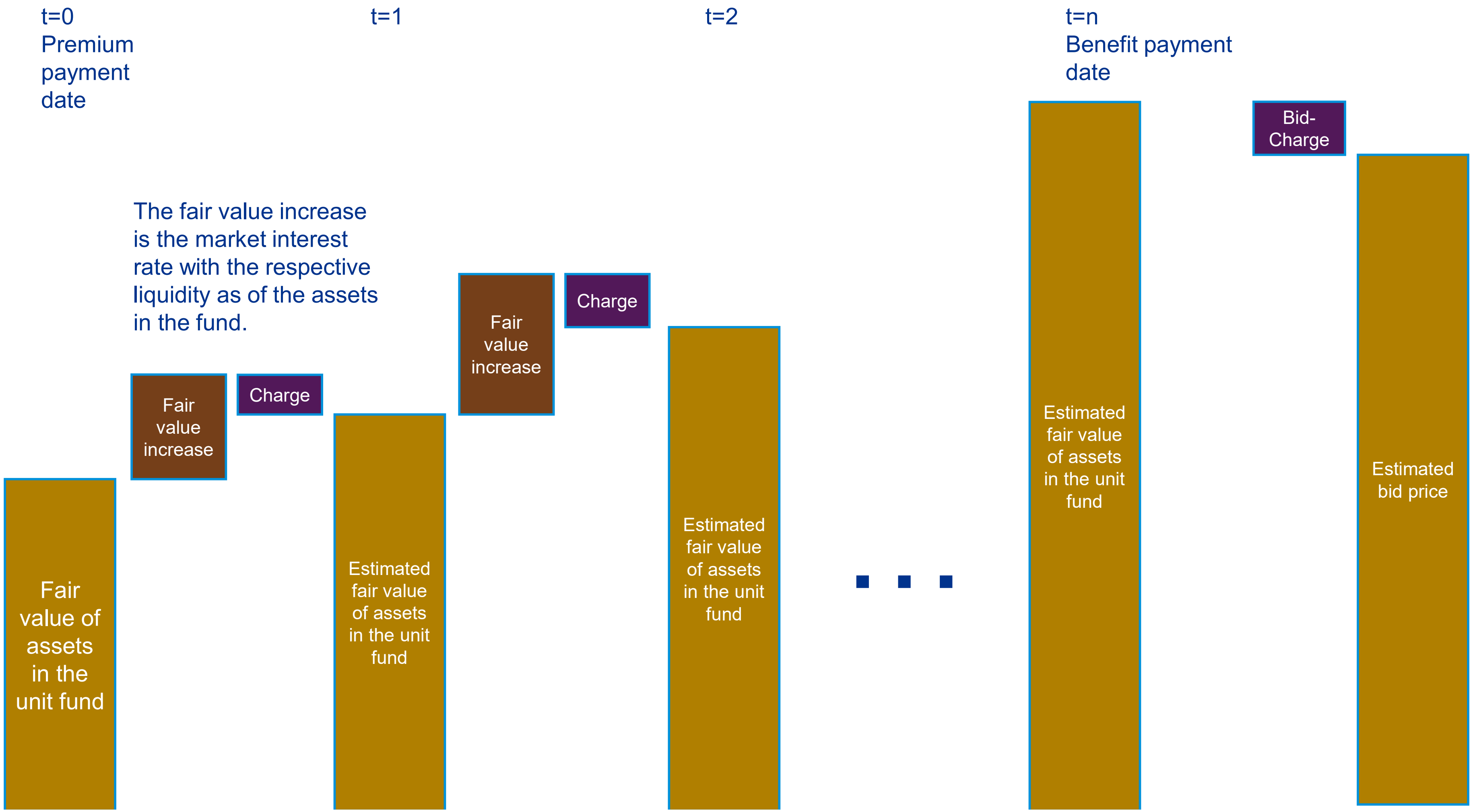
IFRS 17.B101(b) Obligation to p/h in unit-linked

The applicability of the VFA needs to be proven as well for unit-linked contracts!

- The obligation is contractually defined as: The payments at death, surrender and maturity are linked to the **bid price** of a unit fund **at the payment date**, (not the current unit!)
  - The bid price at the payment date is the **fair value of the assets in the fund at the payment date** minus the **bid charge**.
  - The assets in the fund at the payment date are the assets (or replacements) in the fund at the acquisition date minus the **charges made by the fund company** in between.
- At premium payment date, a number of units are allocated to the contract based on the **offer price** of the units (i.e. the value of the assets in the fund plus an offer charge) at that date in the value of the premium, usually after deducting a charge.
- The entity withdraws in each period units to cover its own cost and coverage.
- Further, the fund manager withdraws from the underlying assets charges.
- In addition, the p/h receives a fixed death benefit on top of the funds at time of death financed by the insurer from the charges, not from the u/is.

IFRS 17.B101(b) Obligation to p/h in unit-linked

How does the bid price of the units at the benefit payment date in year n develop? The fund company reduces the assets in the fund annually for own cost. At outset, it is expected that the assets in the fund increase with the risk-free market interest rate (for purposes of applying IFRS 17.B101(b) as well the real world rate might be applied, if higher).



IFRS 17.B101(b) Obligation to p/h in unit-linked

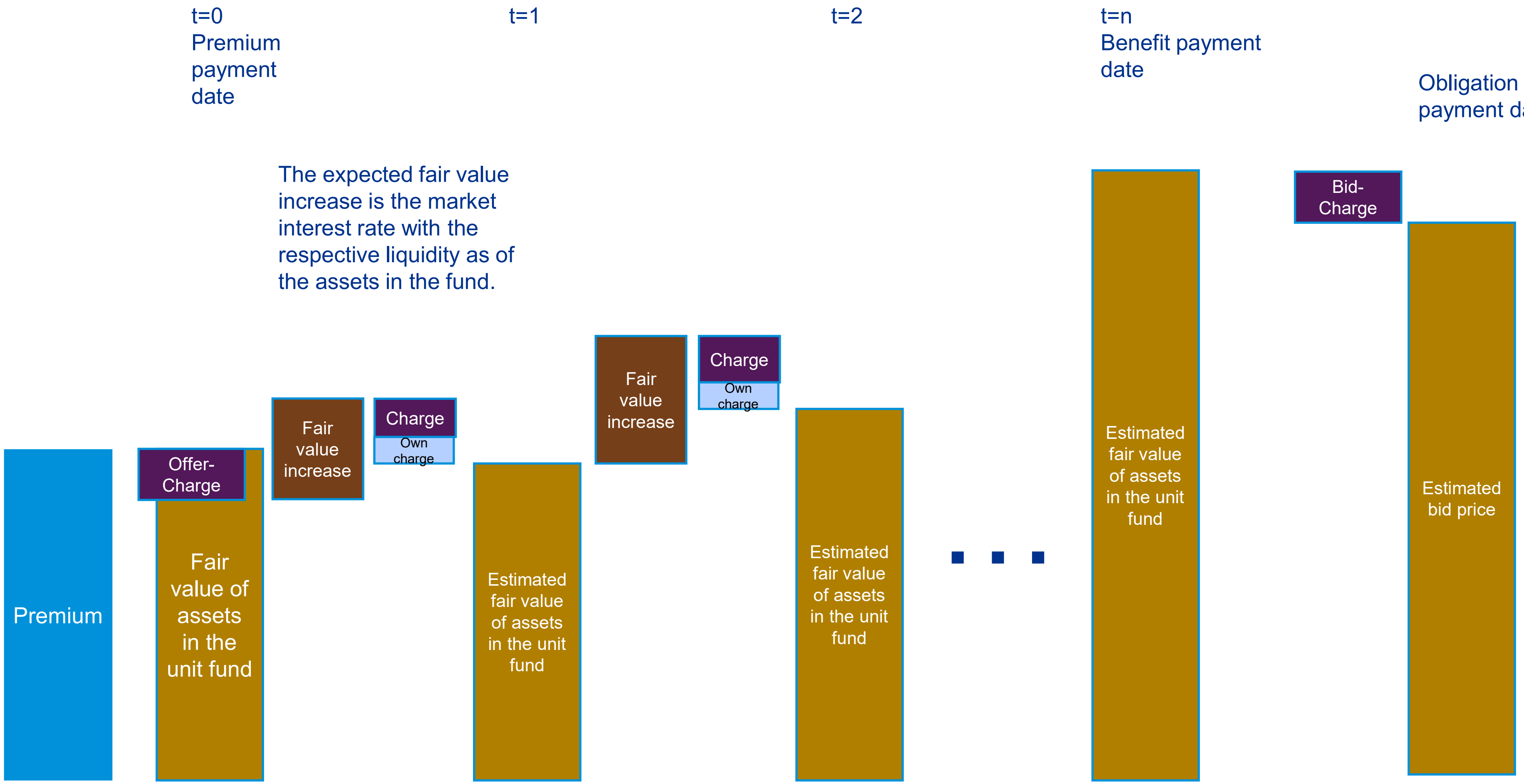
- The picture is not yet complete.
- **The current fair value of the units is not the fair value of the obligation**, i.e. of the units at payment date. The investment company withdraws regularly charges to the underlying assets.
- To determine the fair value of the obligation, it is necessary to correct the current unit price, the fair value of the currently underlying assets, for future charges.
- Relevant is the current fair value of the assets which will remain in the fund at payment date.
- Without considering the charges by the fund manager, the insurer would not have any B65(ka)-cost, it would not provide any management of underlying items, i.e. there are no investment-related services.

IFRS 17.B101(b) Obligation to p/h in unit-linked

- IFRS 17 does not care how the entity invests the premium. The entity could match the obligation, i.e. to provide the bid price of the units at the payment date, as well by holding itself the assets underlying the fund.
- In that case, the entity can withdraw in addition to its own charges as well the charges, which the investment company charges.
- Both ways cannot make a difference in measuring the contract.
  - Accordingly, as well the charges which the investment company makes, count as amounts retained by the entity, i.e. they are as well investment management expenses for investment-related services.
  - The entity pays those amounts, outsourcing the investment to the investment company, as fees to the investment company for the investment services.
  - That explains as well how kick-backs work – they are refunds of charges for outsourcing by the investment company, i.e. they count as negative investment management expenses.

IFRS 17.B101(b) Obligation to p/h in unit-linked

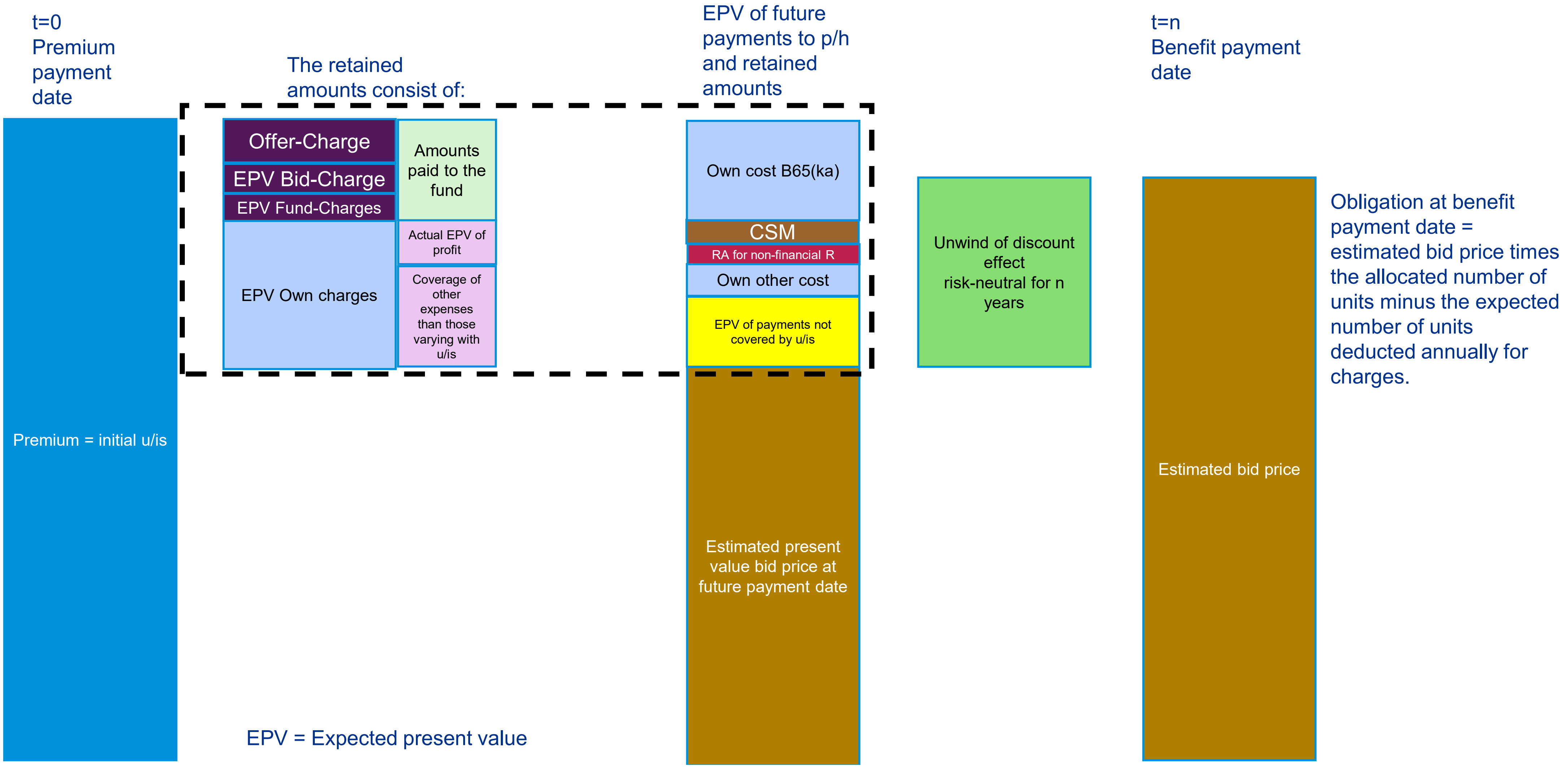
Actually, the insurer deducts each year units from the number of units allocated to the policyholder as own charges and initially the units are allocated to the contract after an initial offer charge. The bid price develops, as outlined before, considering the deductions by the fund company. Charges for own cost of the insurer are in bright, those of the fund company in dark.



The obligation at initial measurement is the present value of this amount at that time, i.e. the present value of this amount (discounted with the market rate) at the initial measurment date.

IFRS 17.B101(b) Obligation to p/h in unit-linked

The today's obligation of the insurer equals the expected present value of the actually payable benefit based on the future bid price. As a result, all charges made by the fund company are included in the CSM. If the entity matches its obligation by actually acquiring the units, it faces annually a return based on the risk-free rate on the assets in the unit-fund and a loss based on the charges by the unit fund. The loss is seen as cost referred to in IFRS 17.B65(ka) and not included in the CSM.



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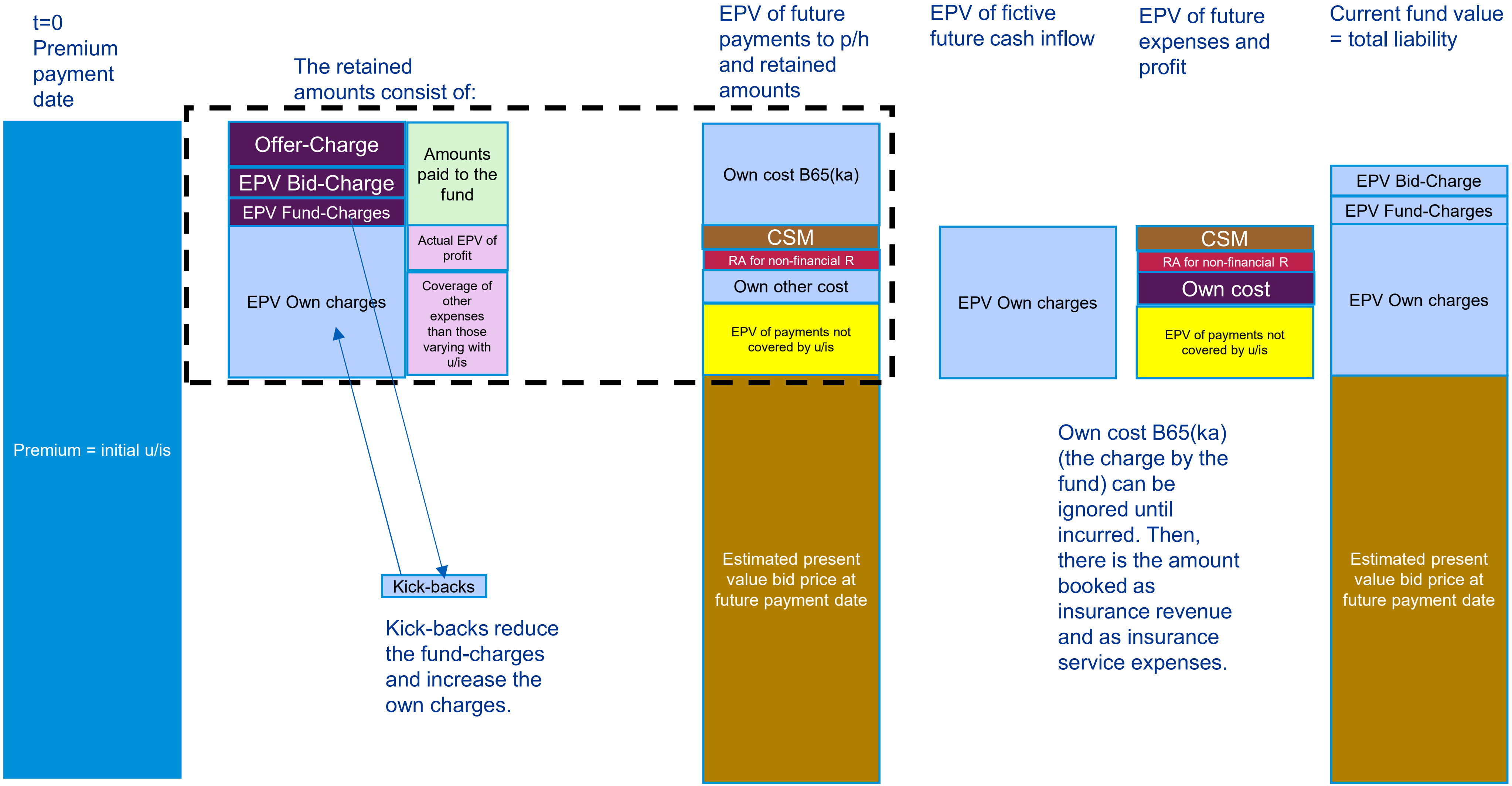
IFRS 17.B101(b) Obligation to p/h unit-linked: Practical

The measurement can be practically proceeded based on the current fund value, considering the EPV of future charges as negative future expenses. The offer charge is considered as an initial insurance revenue and in the same amount initial own cost.



EPV = Expected present value

Explanation

- The own charge of the insurer is not a cash inflow. It is already at outset a part of the CSM, as far as there are not cost included in measurement covered by those own charges.

Conclusion

- The charges by the fund manager, including the offer and bid charges, count as charges made by the entity in applying IFRS 17.B101 (but discounting with real-world rates while in measurement discounting with risk-free rates).
- The current obligation is represented by the expected present value of the bid price of the units at the date of benefit payment to the policyholder times the allocated units minus units deducted for charges (other than charges for coverage services).
- The cost of matching the obligation by holding the respective units, including the implicit or explicit payments to the fund manager, minus any kick-back, count as investment management cost.

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Measurement of cash flows varying with u/is

Cash flows included in the participation mechanism

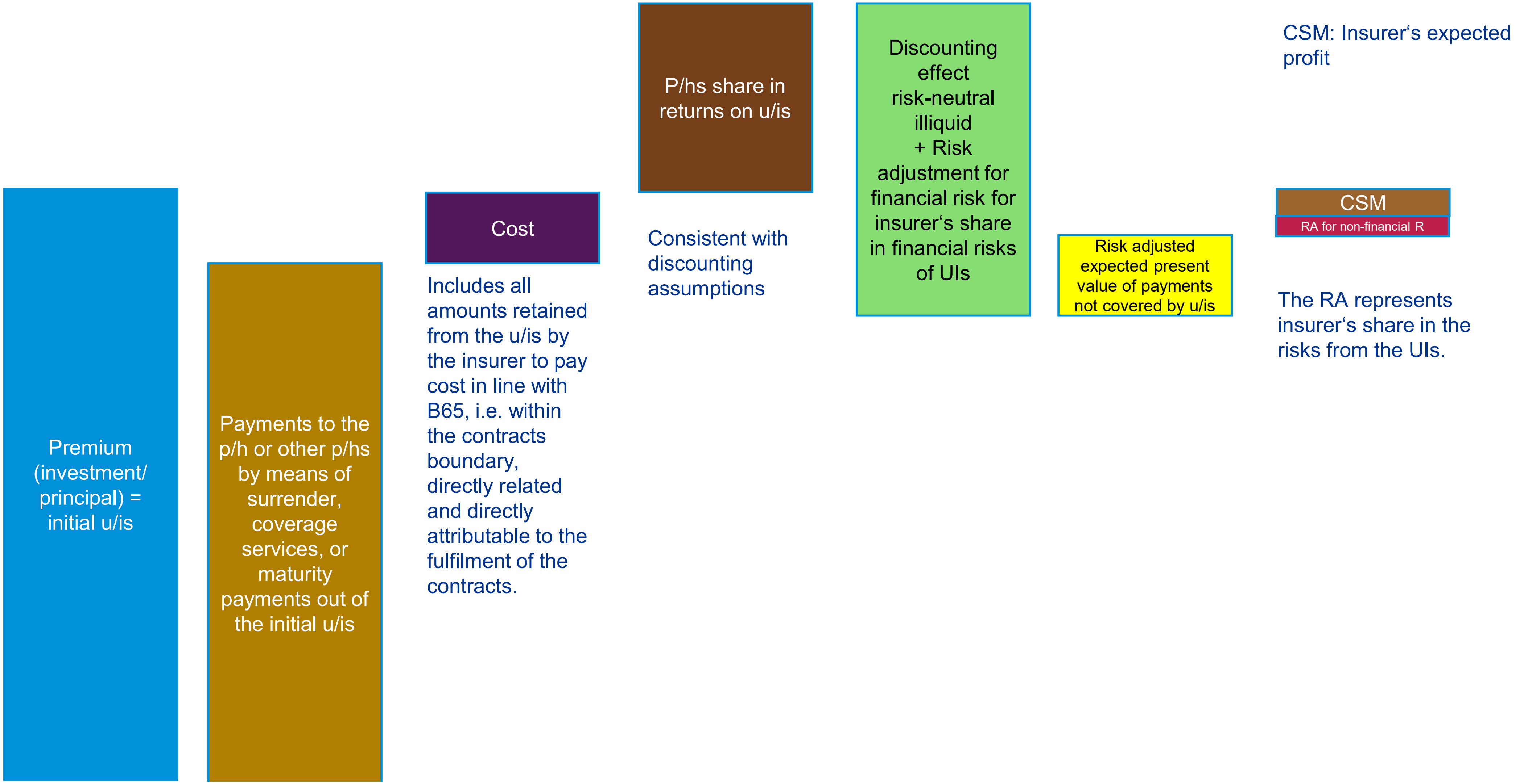
- The cash flows included directly in the FCF are those, which are
  - **directly related** to the fulfilment of the contract **and**
  - **directly attributable** to the fulfilment of contract**s** **and**
  - within the contract boundary.
- This includes in case of direct participating contracts cash flows arising from managing the u/is, since managing the u/is, if those are hold by the entity, is a contractual obligation.
  - This are not the cash flows from the u/is but the cost of proceeding the contractually required managing.
  - Except this, there is no difference in considered cash flows to contracts without direct participation features.

Cash flows included in the participation mechanism

- If only a percentage of investments counts as u/i, as well only a percentage of investment management cost is considered.
- General overhead cost, which are either not directly related or not directly attributable, are not included themselves in the measurement even if they are included in the participation mechanism.
  - However, they are, as far as expected to incur in future and to reduce the payments to the p/h, considered in the estimate of those payments.
  - As a result, the total of such future cost, as far as covered by premiums and returns, is covered accordingly by the CSM.
- Similar applies to expected future cost of reinsurance held.

Initial measurement traditonal par contracts

Picture without general overhead:



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Initial measurement traditonal par contracts

Picture with general overhead:

Premium (investment/ principal) = initial u/is

Payments to the p/h or other p/hs by means of surrender, coverage services, or maturity payments out of the initial u/is

Cost

Includes all amounts retained from the u/is by the insurer to pay cost in line with B65, i.e. within the contracts boundary, directly related and directly attributable to the fulfilment of the contracts.

P/hs share in general overhead

P/hs share in returns on u/is

Consistent with discounting assumptions but considers as well other future effects outside the contract boundary (e.g. realistically assumed cost of reinsurance or general overhead)

Discounting effect risk-neutral illiquid + Risk adjustment for financial risk for insurer‘s share in financial risks of UIs

Risk adjusted expected present value of payments not covered by u/is

CSM: Insurer‘s expected profit and contribution to its financing (e.g. reinsurance, general overhead)

CSM

RA for non-financial R

The RA represents insurer‘s share in the risks from the UIs.

Overhead included in the participation mechanism

- The CSM is released to insurance revenue according to the provision of insurance contract services (ignoring the incurrence pattern of general overhead, which is assumed to be merely fixed).
- Actually incurring general overhead cost are “other expenses” outside the insurance service result.
- Cost of reinsurance held is inside the insurance service result.
- If incurred as expected, there is no further effect. The amounts are withdrawn from the insurer’s part of the u/is, there is no effect to the liability.
- If there is a deviation, the p/h’s share and the insurer’s share (including the CSM applying IFRS 17.B112) are adjusted accordingly and the effect is immediately presented in insurance revenue (IFRS 17.B111).

Risk adjustments for financial and non-financial risk

- IFRS 17.36 and 37 require to adjust the expected present value of cash flows (discounted reflecting the time value of money) for financial and non-financial risk born by the insurer.
- The risk of the insurer, i.e. the uncertainty of the net cash flows and their timing, can result from
  - the uncertainty of insurer's share in the return of the u/is resulting from the
    - uncertainty of the returns of the u/is and from the
    - asymmetries in the algorithm deriving the insurer's share from the returns
  - the uncertainty of cash flows not varying with the u/is
- Uncertainties born by p/hs are not considered (participation is normally a risk-reducing feature)

Risk adjustments for financial and non-financial risk

- Uncertainty of the returns of the u/is: The value of each individual u/i at the time of determining insurer’s and p/h’s share is uncertain. This uncertainty in value is financial risk (IFRS 17.B128(a)) as an accounting convention, even if that does not comply with definition (e.g. if the rights to a reinsurer are an u/i).
- Asymmetries in the algorithm deriving the insurer’s share from the returns include
  - if policyholders share in mortality but as well the insurer, more or less death claims cause less or more insurer’s share in the returns – this is non-financial risk.
    - It is not a change in the value of u/is, since it is just an issue of timing of repayment of u/is to p/hs, whether it is paid as death benefit earlier or as maturity benefit later.
- The uncertainty of cash flows not varying with the u/is include
  - the uncertainty of minimum interest guarantees in the money, which cannot be recovered by mutualisation. This is financial risk.
  - Risks from other cash flows not varying with the u/is are classified applying the definition of financial risk and non-financial risk.

Risk adjustments for financial and non-financial risk

- Risk adjustments are part of insurer's variable fee but presented separately from the CSM as part of the FCF.
- Risk adjustments are FCF that, except those representing insurer's proportional risk in the u/is, do not vary with the u/is.
- IFRS 17 permits to measure the obligation to the p/h assuming that the u/is develop in line with
  - fair value-theory, i.e. the risk-adjusted return equals the risk-free return. In that case, the FCF are measured with consistent assumptions on that basis.
  - real world expectations. In that case the cash flows to the p/h are respectively higher and as well the discount rate is higher. However, insurer's share needs to be adjusted with a respectively higher risk adjustment for financial risk ensuring that the CSM is a risk-free equivalent.

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VFA-Measurement: IFRS 17.B111-B112

Reminder: IFRS 17.B104

- IFRS 17.B104(a) defines the “obligation to pay the policyholder an amount equal to the fair value of the underlying items”. It is, accordingly, the fair value of the underlying items.
- This amount splits in the
  - amount included in the expected present value of future cash flows, the policyholder’s share and the
  - insurer’s share.
- The phrase in IFRS 17.B104(a) is referred to only twice in IFRS 17, the second time in IFRS 17.B111.
- IFRS 17 establishes therefore for the measurement of direct par contracts a two-step process:
  1. Determining the changes in the “obligation to pay the policyholder an amount equal to the fair value of the underlying items” (IFRS 17.B104(a) and B111)
  2. Determining how that amount splits between the FCF and the CSM (IFRS 17.B112 and B113).
- To note: There is a third step if the measurement of the cash flows not varying with the u/is are affected by the change in value of the u/is, which usually incurs if those cash flows are negatively correlated with the u/is (e.g. the excess of death benefits over the u/is if they are defined the larger of a fixed sum insured and the u/is).

IFRS 17.B111

- IFRS 17.B111 determines therefore that the total effect of any change in value of “**the** underlying items” (= pool of underlying items) to the liability does not adjust the CSM, i.e. is presented in comprehensive income, if not being an investment component or a premium receipt (or refund).
- It does not determine how the building blocks are affected or how changes in the liability or building blocks for other reasons than a change in the value of the pool of underlying items is accounted for.
- It does as well not determine in which line of comprehensive income the change of the liability is presented or whether it is a booking to other B/S items (i.e. for investment components, premiums or premium refunds).
- IFRS 17.B111 is relevant for all cases where the total fair value of the pool of underlying items changes, for what reason ever.
  - To be noted, IFRS 17.B111 does not include a caveat as in IFRS 17.B128(c), which refers only to changes in the fair value of underlying items (without “**the**”), which are neither additions nor withdrawals.
  - Accordingly, IFRS 17.B111 refers as well to all cases where the fair value of the pool of underlying items changes since items where added to the pool of underlying items or items were withdrawn from it.

IFRS 17.B112

- IFRS 17.B112 refers to any change in the insurer's share, i.e. in the amount in IFRS 17.B104(b)(i), which includes, regarding building blocks, parts of the risk adjustment for non-financial and financial risk and parts of the CSM.
- Insurer's share may change since
  - the value of the u/is (be it due to positive or negative returns or due to additions or withdrawals)
  - a movement within the expected present value of future cash flows which is (partly) shared, i.e. off-set by a change in insurer's share or
  - the insurer changes within its discretion its intended share (IFRS 17.B105).

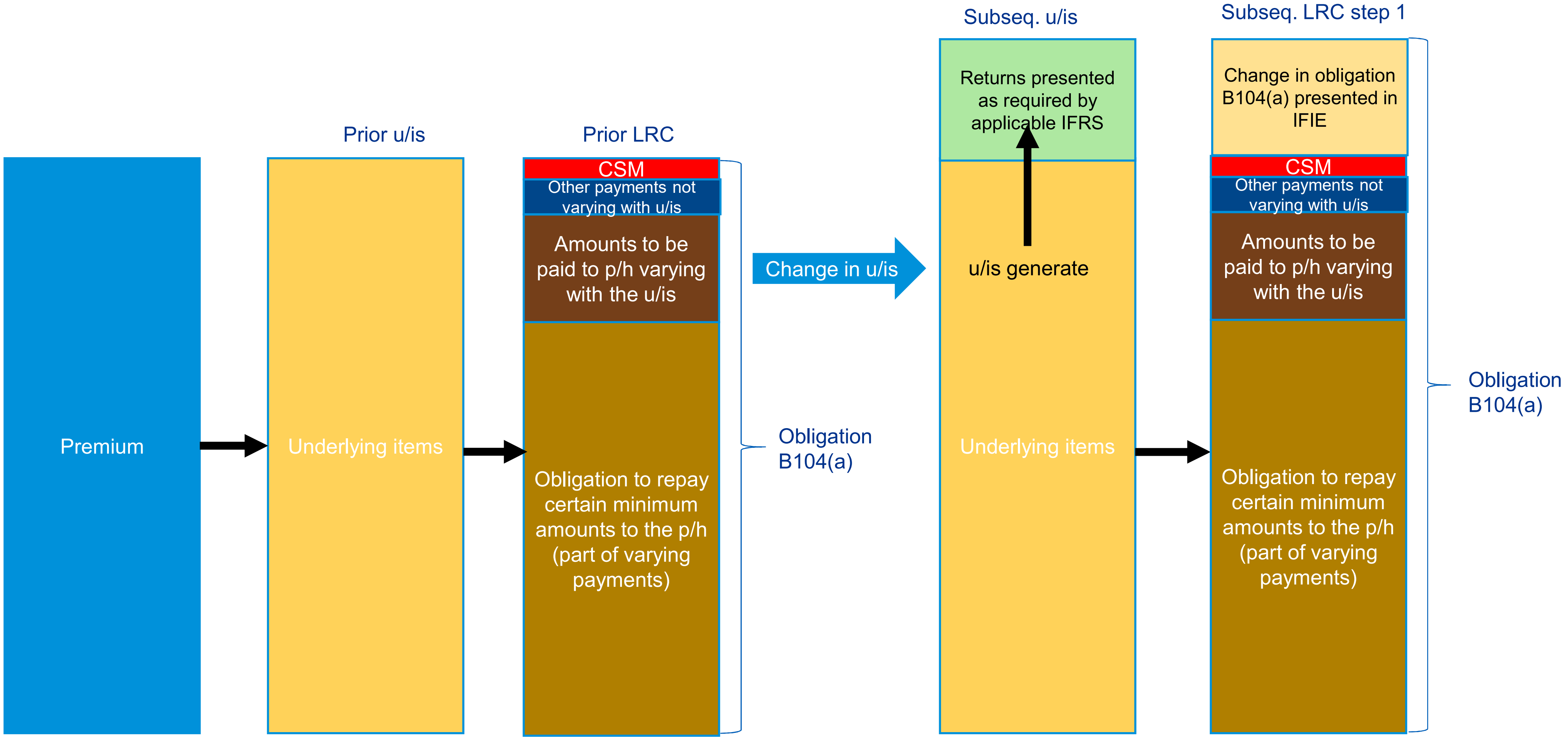
IFRS 17.B112

- IFRS 17.B112 does not refer to cases, where there are changes of cash flows covered by insurer’s share, i.e. of amounts referred to in IFRS 17.B104(b)(ii).

IFRS 17. B111 Changes due to returns on the u/is

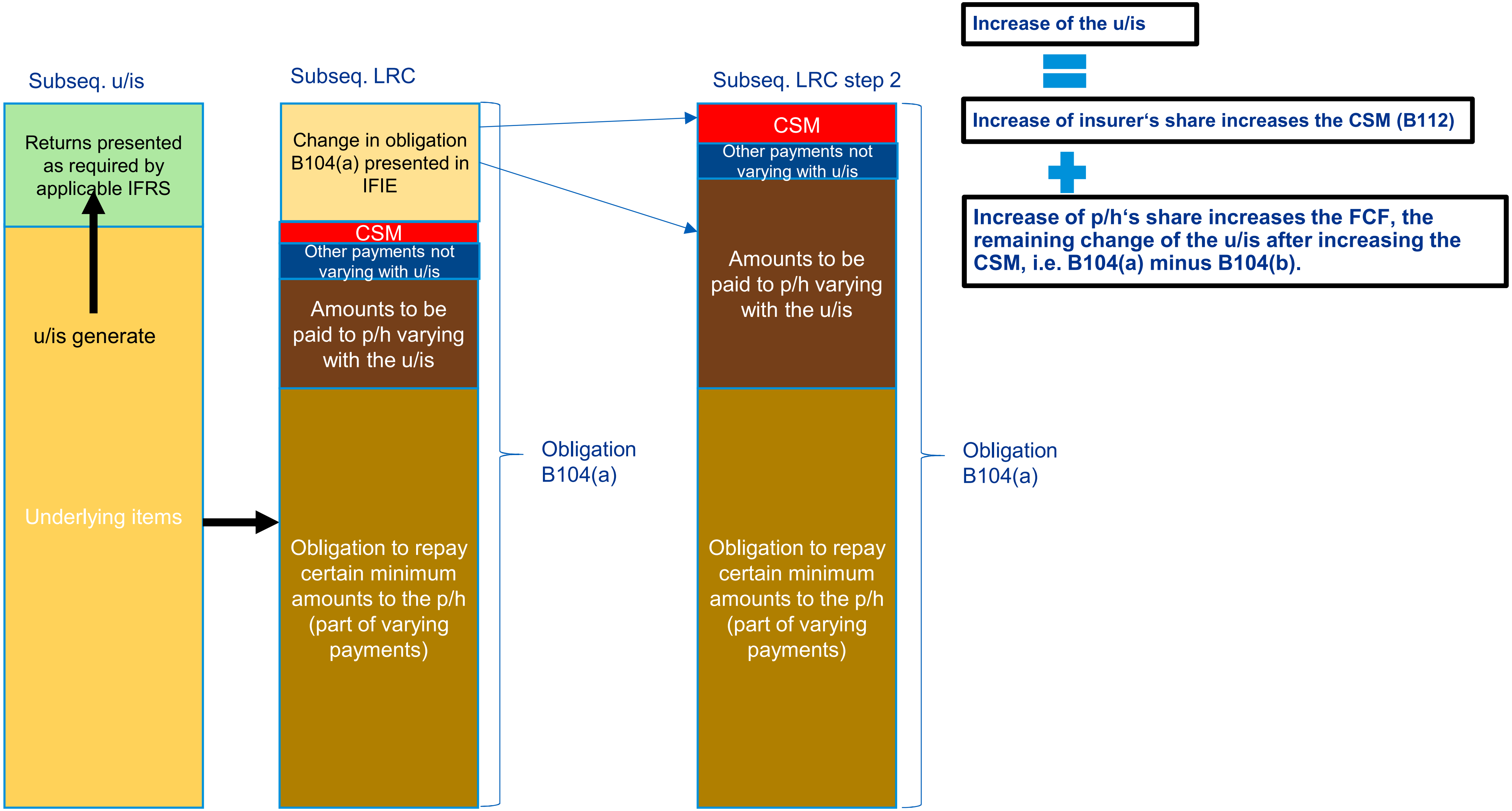
For simplification, discounting and risk adjustments for financial and non-financial risks are ignored.

Obligation changes since the u/is are increased by returns. First step, increase of obligation (before changing the composition of the LRC: Returns, if investments in the scope of IFRS 9 FVPL, are presented as invstment gains. Since it is a change in value of the u/is, B128(c) requires presentation of the change in the LRC as IFIE (even if the returns on u/is, if held by the entity, are not presented as financial returns).



IFRS 17. B111 Changes due to returns on the u/is

Second step: Review of the composition of the LRC. The change of the u/is is split: The insurer's share increases and the amounts to be paid varying with the u/is increase. The total amount of the LRC does not change, there is no impact to P&L.



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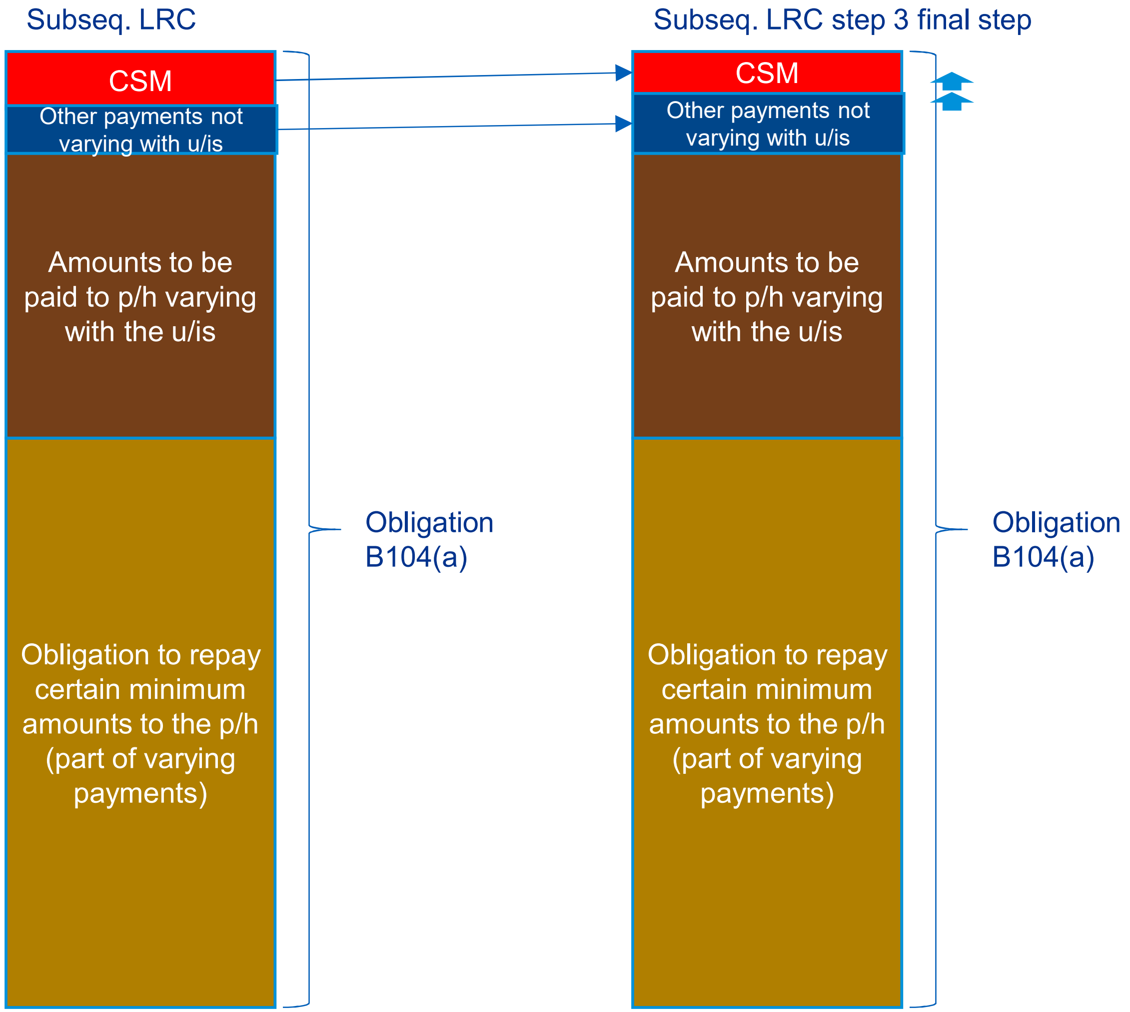
IFRS 17. B111 Changes due to returns on the u/is

Third step: Review of the payments not varying with the u/is. Those payments may change, e.g. due to the change in value of minimum guarantees caused by the returns achieved. B113(b) requires to adjust the CSM for the change in the payments, i.e. there is no impact to the total LRC and no impact to P&L.



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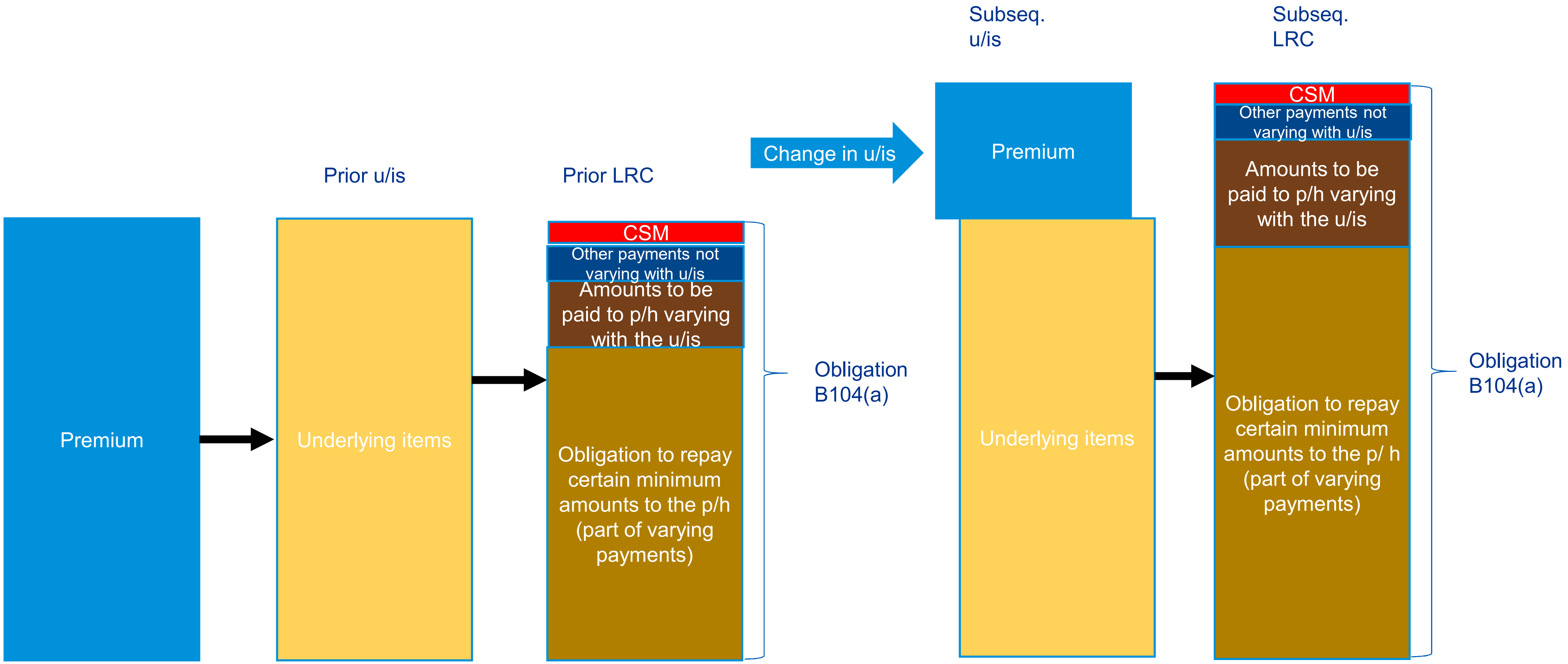
IFRS 17. B111 Changes due to additions (premiums)

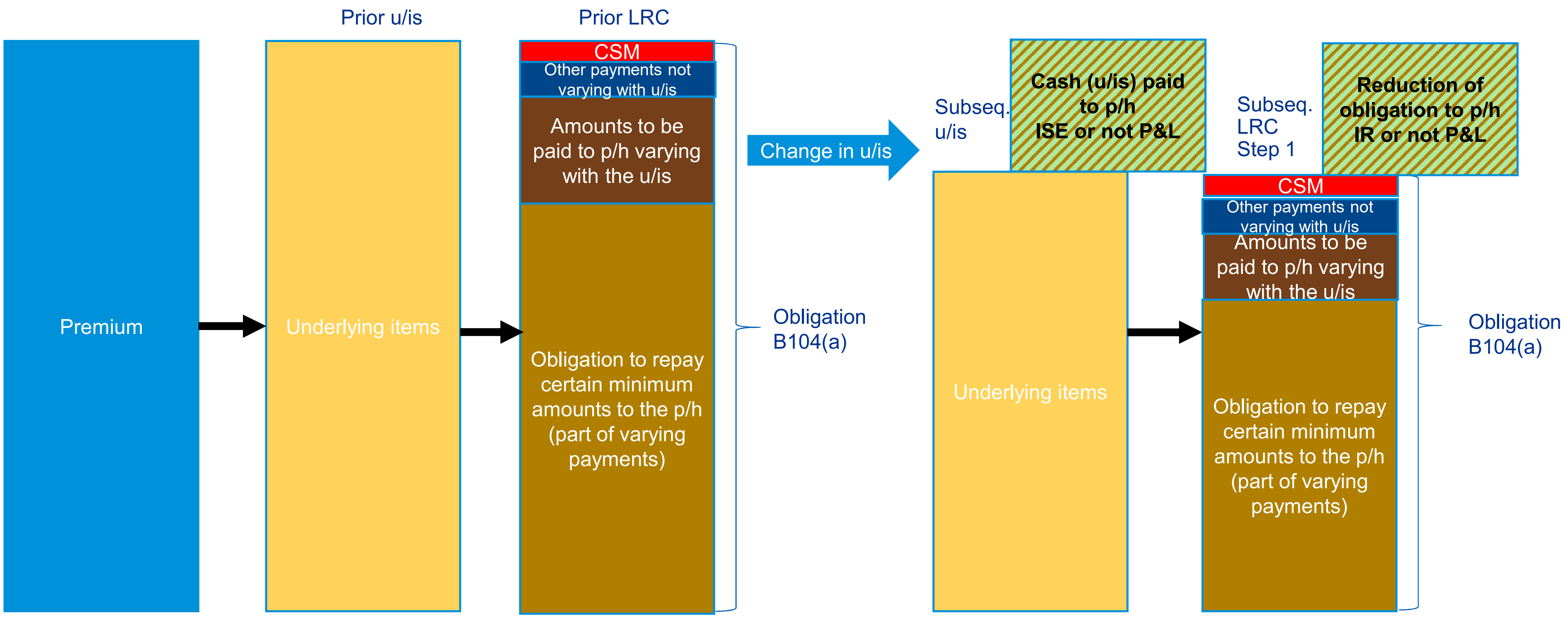
Obligation changes since the u/is change due to the payment of a premium. Effect: DIncrease of obligation. The change of the u/is is not a return. It is due to receipt of a premium. The increase of the LRC represents the receipt of the expected premium, it is not presented in P&L as a premium receipt but reflects the change in cash of the entity.



IFRS 17. B111 Changes due to withdrawals (death benefit)

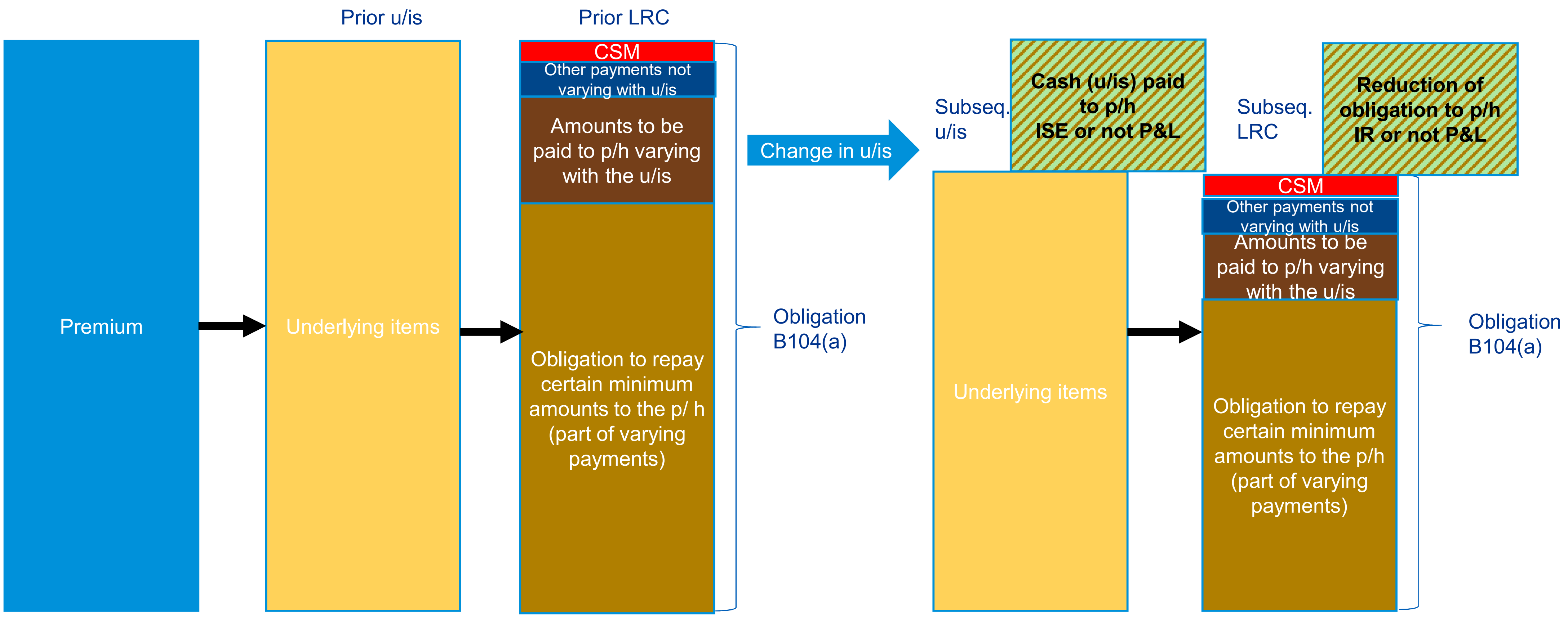
In some collective participation systems, death benefits are not paid from insurer's share but nearly entirely from the collective u/is, i.e. the payment reduces and therefore fulfils the obligation to the collective of p/h. The death benefit is paid on behalf of all p/h.

First step: As fulfilment of the obligation, the release of the LRC is presented as insurance revenue, the payment as ISE. It is not a change in the value of any of the u/is – u/is in the amount of the death benefit are withdrawn from the u/is (i.e. are no longer u/is) and transferred to the p/h.



IFRS 17. B111 Changes due to withdrawals (death benefit)

Obligation changes since the u/is change due to the payment of a part of the obligation to the p/h (withdrawal in the sense of B128(c)), i.e. the insurer fulfills a part of the obligation by payment. Effect: Decrease of obligation. The change of the u/is is not a return. It is due to the fulfilment of the obligation. The reduction of the LRC represents the fulfilment of the obligation of the insurer, i.e. it is presented in insurance revenue or not presented in P&L if an investment component or a premium refund. The reduction of the u/is is accordingly presented in insurance service expense or not presented in P&L.



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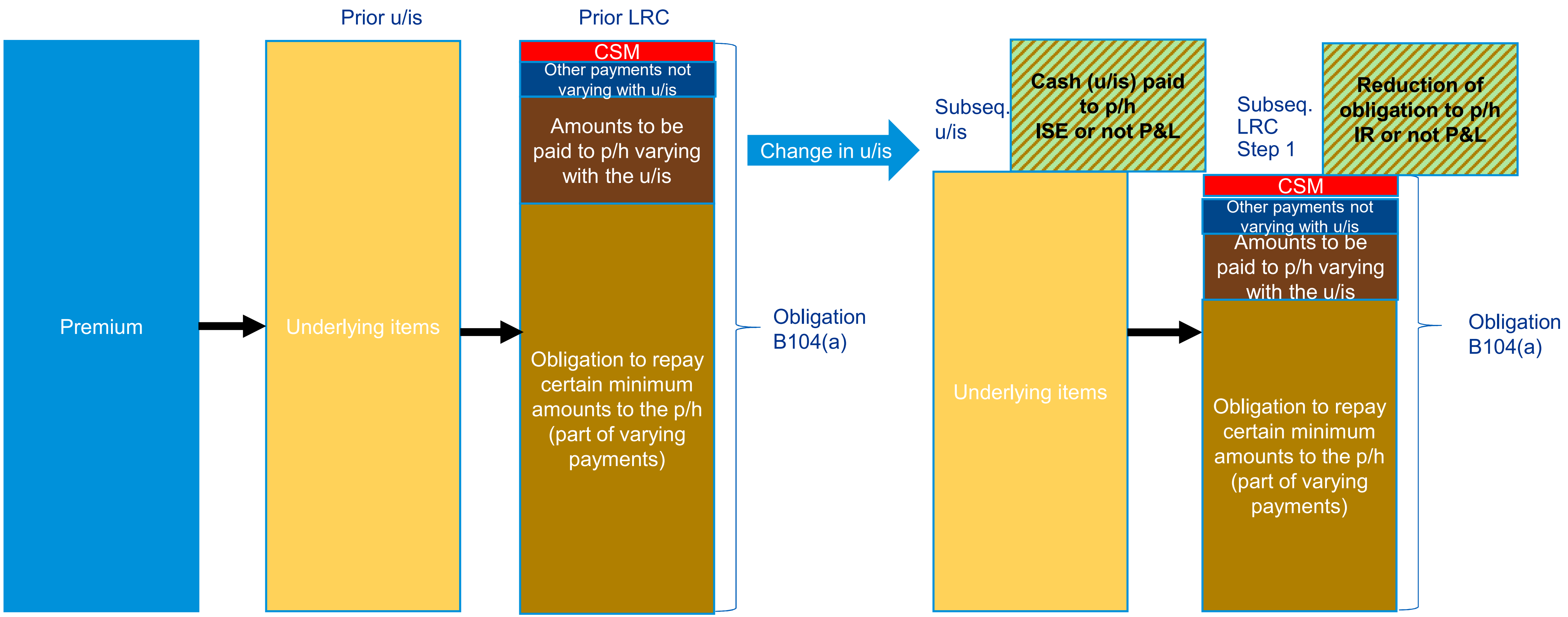
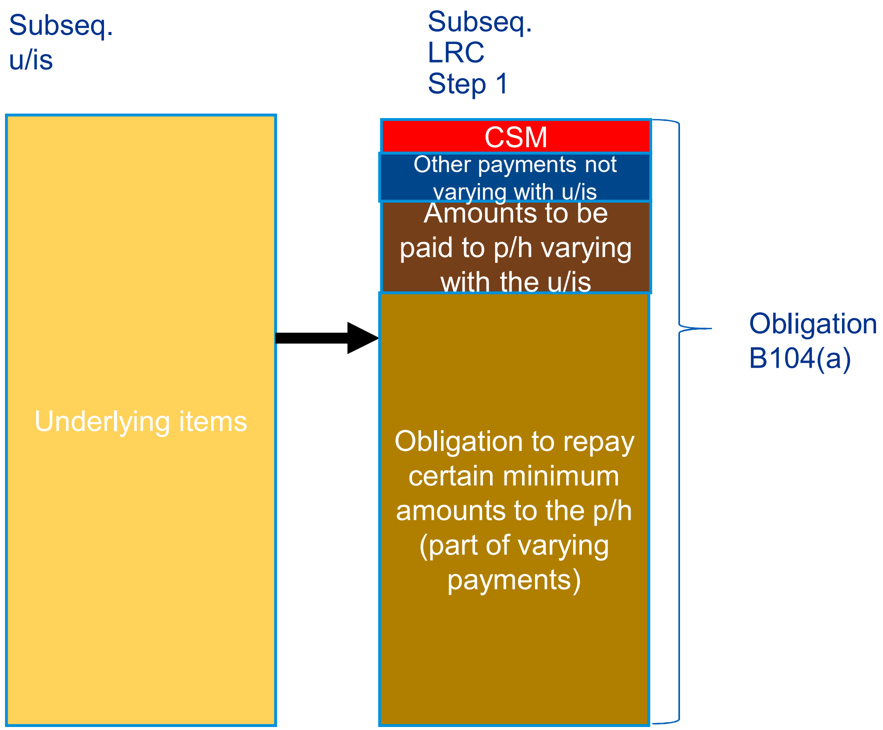
First step: As fulfilment of the obligation, the release of the LRC is presented as insurance revenue, the payment as ISE. It is not a change in the value of any of the u/is – u/is in the amount of the death benefit are withdrawn from the u/is (i.e. are no longer u/is) and transferred to the p/h.

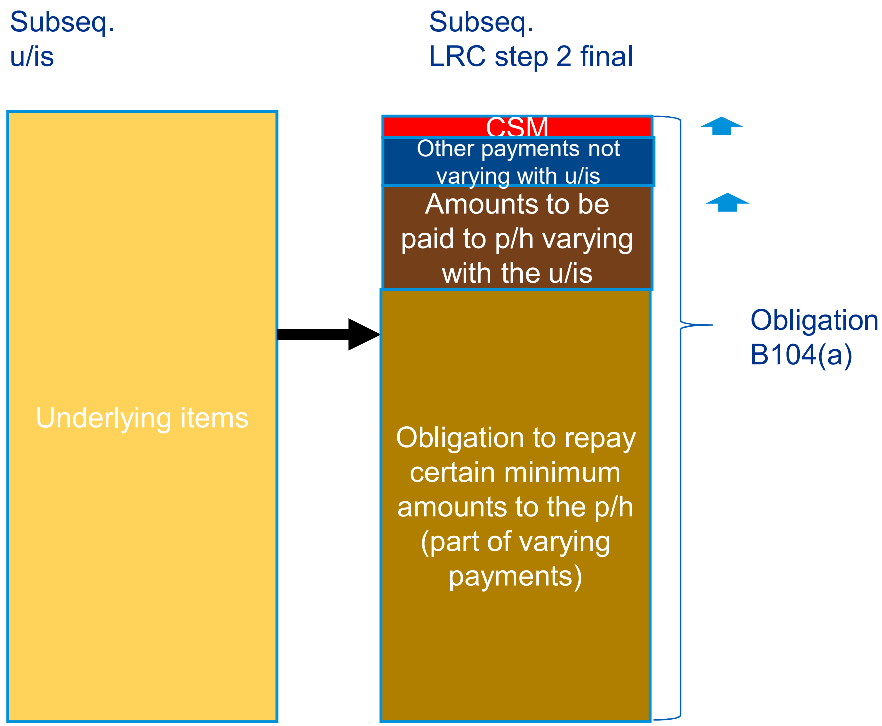


IFRS 17. B111 Changes due to withdrawals (death benefit)

Second step: Paying more or less death benefits than expected may decrease or increase insurer‘s share in the u/is. According to B112, that change adjusts the CSM, i.e. the effect of the death benefits to insurer‘s profit is not presented in P&L. The full amount of the death payment is presented as insurance revenue and ISE.

Here it is assumed that there are more death benefits than expected paid, i.e. insurer‘s share in the u/is is reduced slightly.





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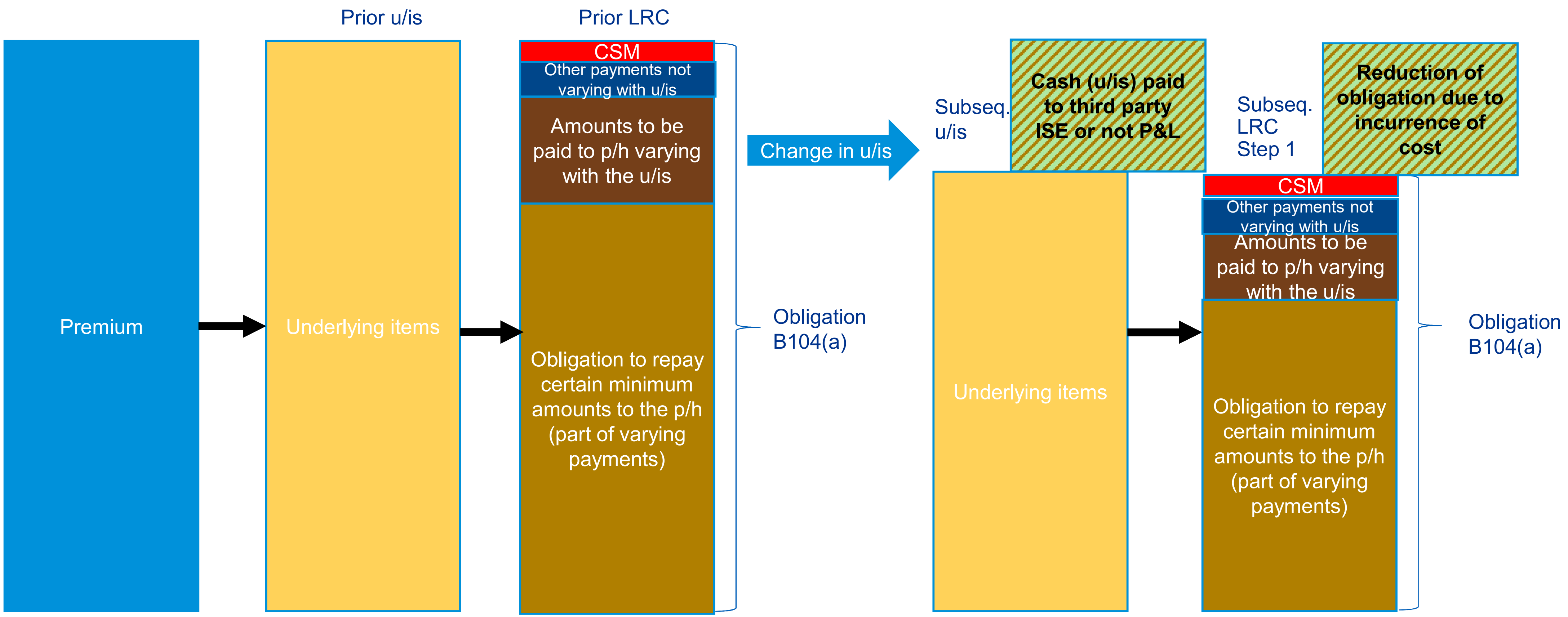
IFRS 17. B111 Changes due to withdrawals (cost)

In some collective participation systems, cost actually incurred are not paid from insurer's share (although insurer's share may be affected by the cost e.g. at a certain percentage) but is paid from the collective u/is, i.e. the incurrence of cost reduces and therefore fulfils the obligation to the collective of p/h. However, it is not a payment to p/hs, it is not a benefit or provision of service (except cost for providing benefits in kind).It is nevertheless a „change in the obligation to pay the policyholder an amount equal to the fair value of the underlying items" (B111). Accordingly, it does not adjust the CSM.

First step: U/is and LRC is reduced. It is not a change in the value of any of the u/is – u/is in the amount of the cost are withdrawn from the u/is (i.e. are no longer u/is). Applying B112, the reduction of the obligation does not adjust the CSM.



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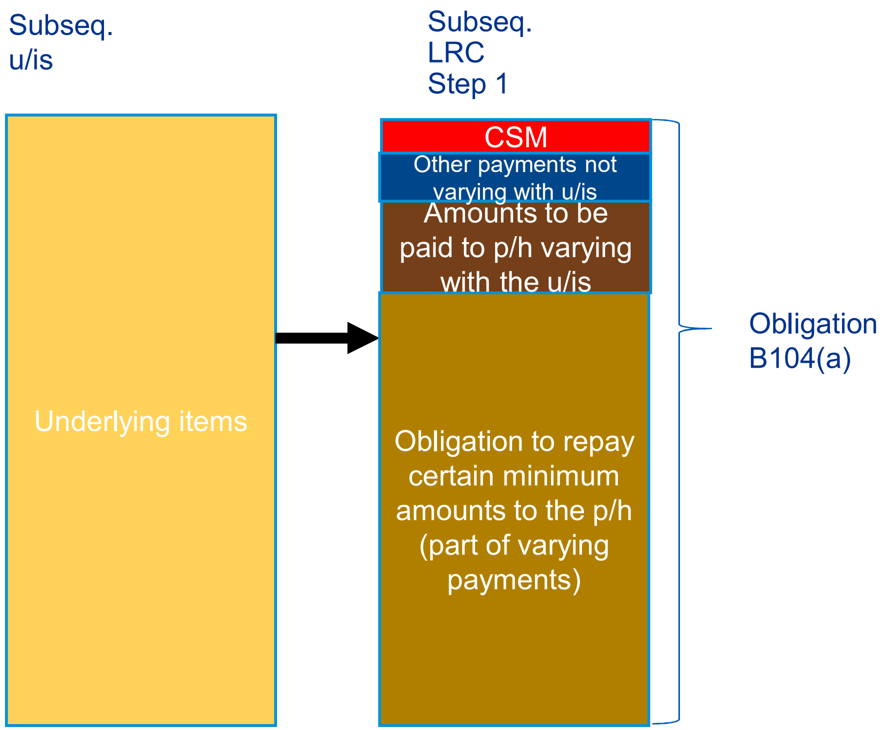
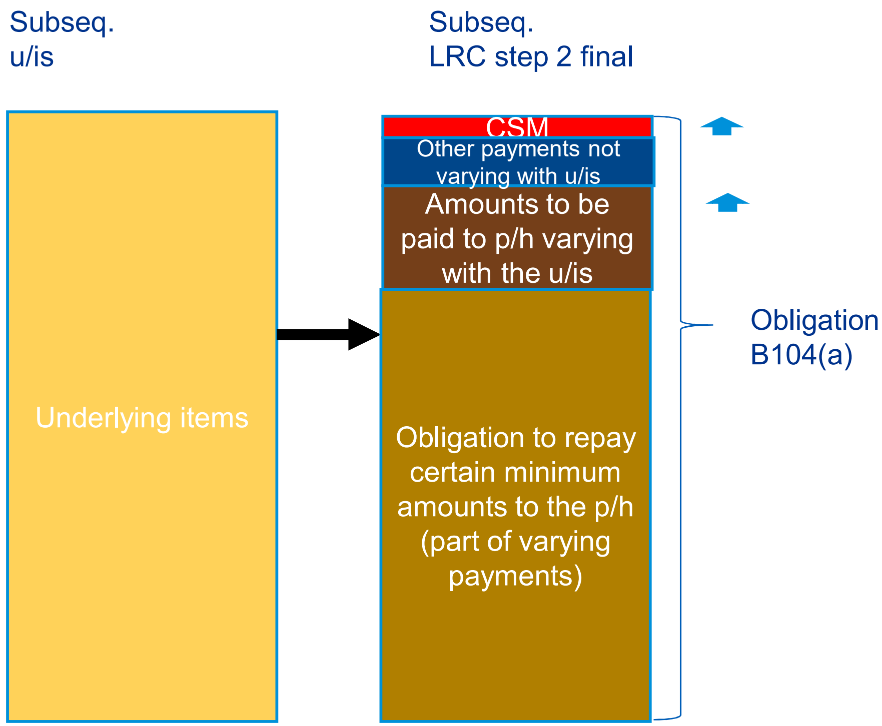
IFRS 17. B111 Changes due to withdrawals (cost)

Second step: Paying more or less cost than expected may decrease or increase insurer's share in the u/is. According to B112, that change adjusts the CSM, i.e. the effect of the cost to insurer's profit is not presented in P&L.

Here it is assumed that there are more cost than expected paid, i.e. insurer's share in the u/is is reduced slightly.





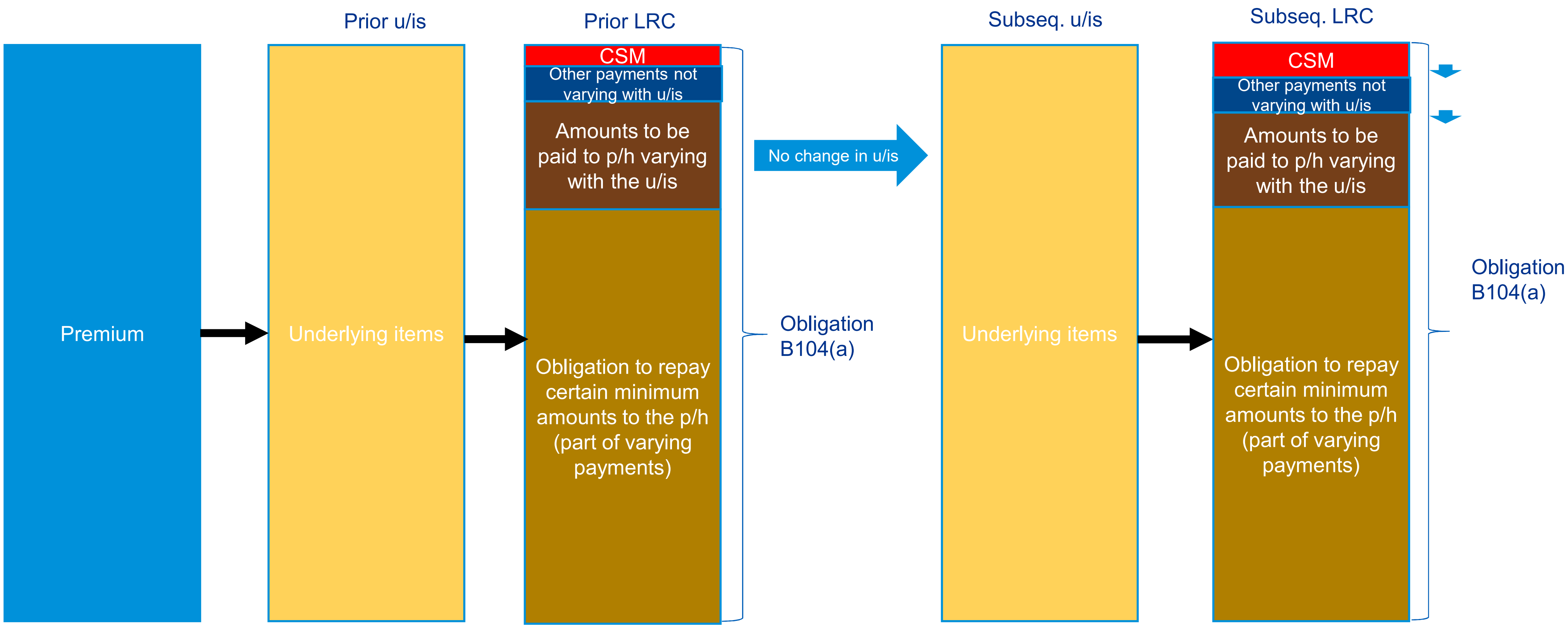
Explanation

- The incurred cost are insurance service expenses (IFRS 17.84).
- The incurrence of the cost reduces both,
  - the u/is by withdrawing assets from the u/is (that is a contractual, not an accounting consequence) and
  - the LRC since the total obligation is reduced
    - FCF is reduced since expected cost are released and any compensating effect due to deviations from the expected amount changes p/hs' share and
    - the CSM is adjusted for any impact to insurer's share.
- Clearly, the expected cost are released from the FCF and presented as insurance revenue (B124(a)).
- Any deviation from the expected amount is an amount which is an amount changing future cash flows and insurer's share, but does not adjust the CSM (B112), since it is caused by a change in the u/is (in difference to B96(b) for the GM).
- Hence, this change in the LRC needs to be presented in P&L. It is not an effect of financial risk (it is the difference between the actually incurred cost and the cost expected to incur as at the end of the prior period). It is not IFIE according to IFRS 17.87. It will be discussed later why it does not represent a change in the fair value of u/is (excluding withdrawals) considering IFRS 17.B128(c).
- Accordingly, this change in the liability, as a release of past premiums as compensation for services provided in the current period, is to be presented as insurance revenue. The entity is effectively released from the obligation to pay that part of the underlying, although deviating from the original expectation.

IFRS 17. B112 Changes in insurer' share

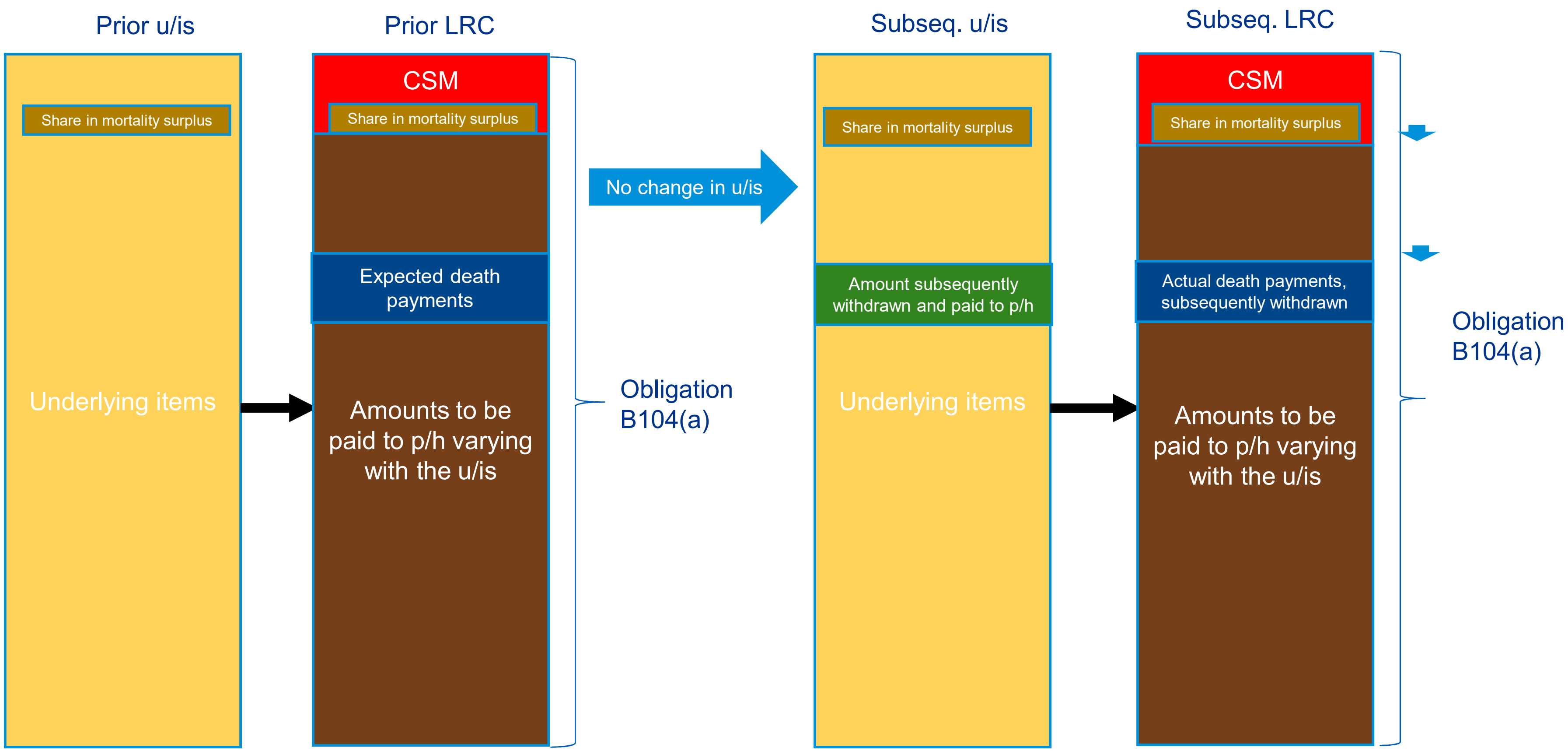
For simplification, discounting and risk adjustments for financial and non-financial risks are ignored.

The u/is remain unchanged but the insurer's share changes. 1) The insurer may discretionary decide to charge more or less within the range of discretion granted by the contract. 2) Changes in the obligation (e.g. in case of more complex fee formulas depending on the composition of the partial obligations) cause a change in the split between insurer and p/hs. According to B112, the CSM simply increases and the varying payments to the p/h decrease in the same amount.



IFRS 17. B112 Changes in insurer' share

The u/is remain unchanged but the insurer's share changes. Practical example: In case of a contract where p/h share as well in mortality, the insurer owns a certain percentage of the difference between the contractual risk premium and the actually incurred claims. Lower claims incurred than expected result in a higher insurer's share. The amount withdrawn from the u/is is the actual payment in case of death. As a result, without a change in the total value of the u/is, the insurer's share increases, adjusting the CSM. The actual death benefits are subsequently withdrawn from u/is and the obligation under B104(a).



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Entries of insurer's share

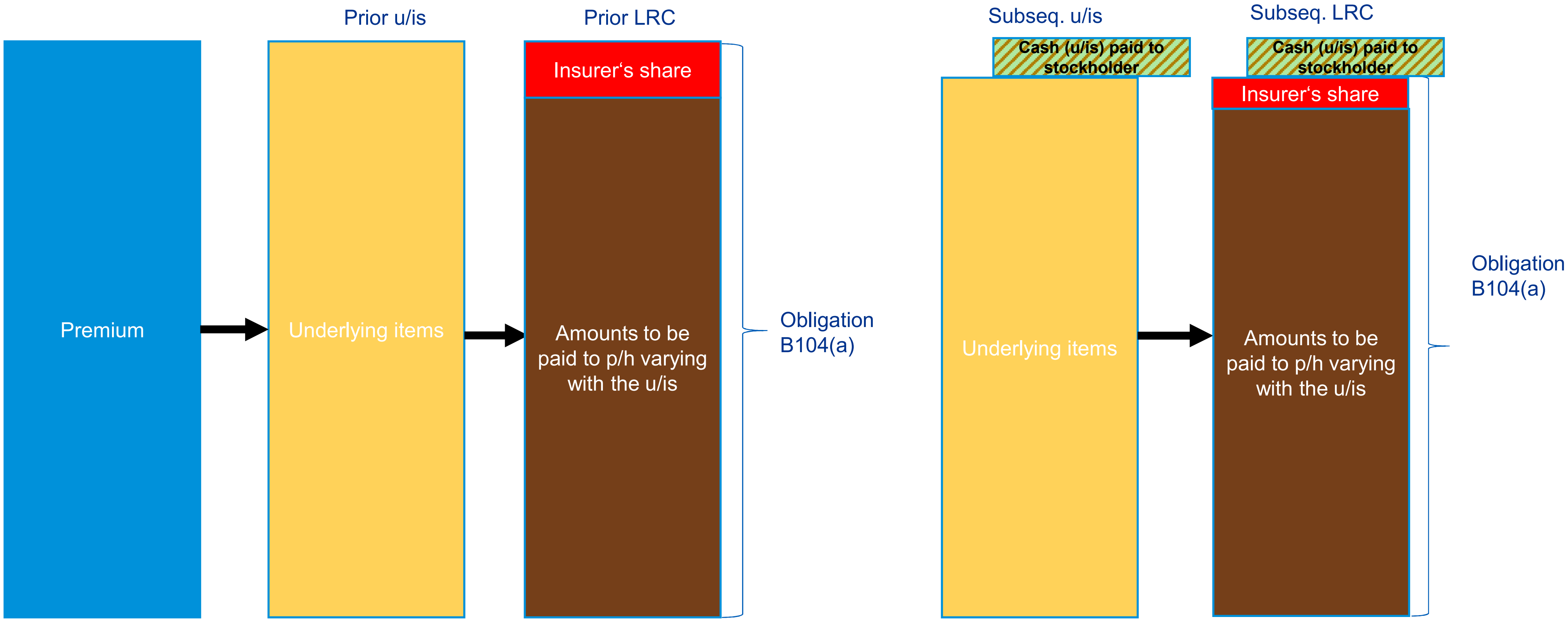
IFRS 17. B104(b)(i) Insurer' share and u/is: Dividend to s/hs

For simplification, up to now it was assumed that insurer's share and the CSM remain in the u/is.

But actually, the CSM is released and insurer's share is withdrawn, in some cases, the insurer may even add u/is. Insurer's share comprises insurer's profit, risk adjustments and cash flows not varying with u/is. Withdrawals could be paying a dividend to stockholders, withdrawing the money from the u/is to general funds, paying non-varying cash flows to p/hs or third parties. The release of risk adjustments or CSM without withdrawing the money from the u/is causes, that the u/is cover as well a part of equity.

First case: The insurer withdraws a part of its share from the u/is by paying a dividend to the stockholders, taking cash out of the u/is.

That reduces the insurer's share in the u/is. What are the measurement consequences if that incurs before the respective CSM is released?



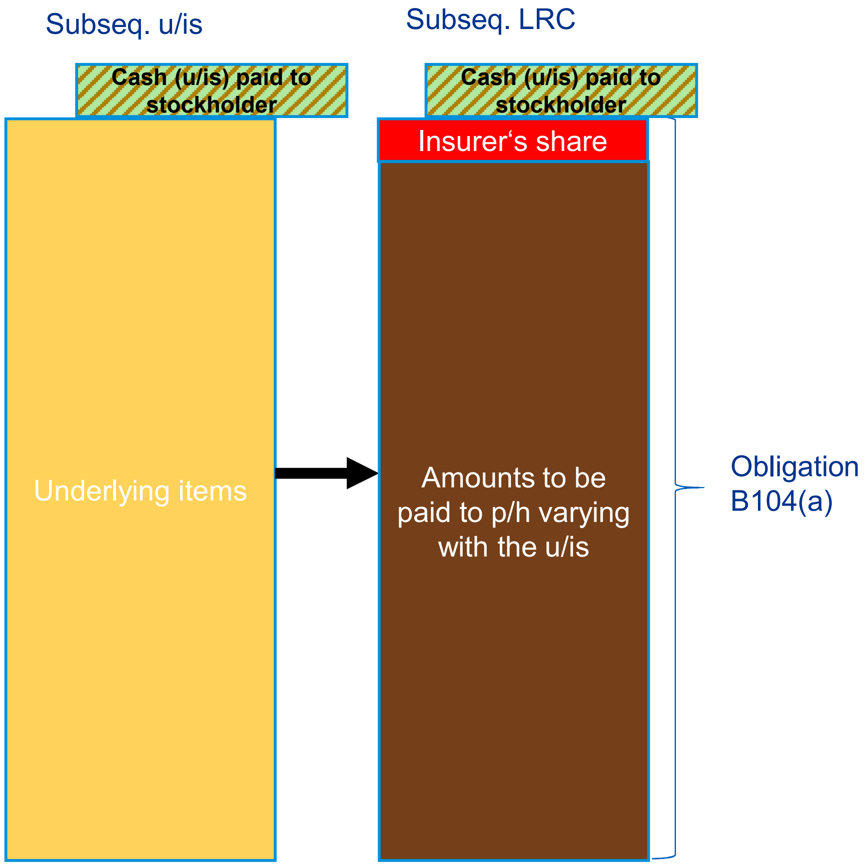
IFRS 17. B104(b)(i) Insurer' share and u/is: Dividend to s/hs

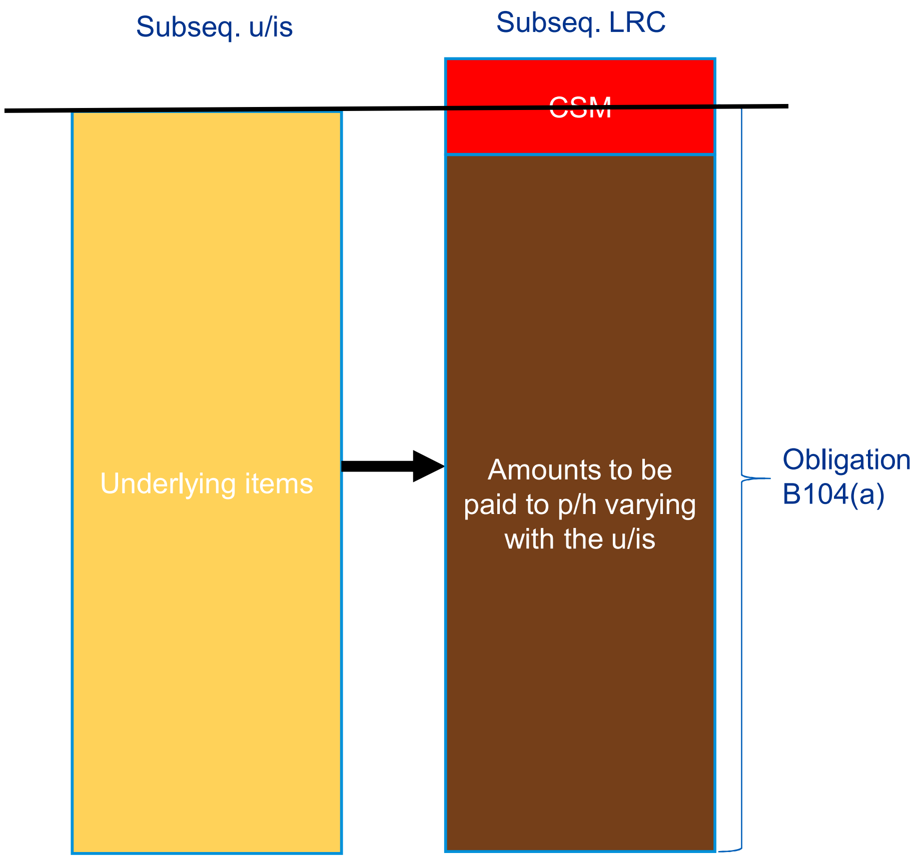
First case: The insurer withdraws a part of its share from the u/is by paying a dividend to the stockholders, taking cash out of the u/is.

That reduces the insurer's share in the u/is. What are the measurement consequences if that incurs before the respective CSM is released?

The change in the obligation to pay the FV of u/is to the p/hs due to a withdrawal of insurer's share does not adjust the CSM (B111). It is not a change in the insurer's share (B112), but simply a payout of insurer's share. It is here necessary to differentiate between a change (in value) and a withdrawal, otherwise B111 and B112 would be in contradiction.

From now onwards, a part of the CSM is not covered by the u/is. That part represents the part of the insurer's share which is already withdrawn. Similarly, as well the risk adjustment or cash flows not varying with u/is might not be covered by the u/is since the amounts are already withdrawn.

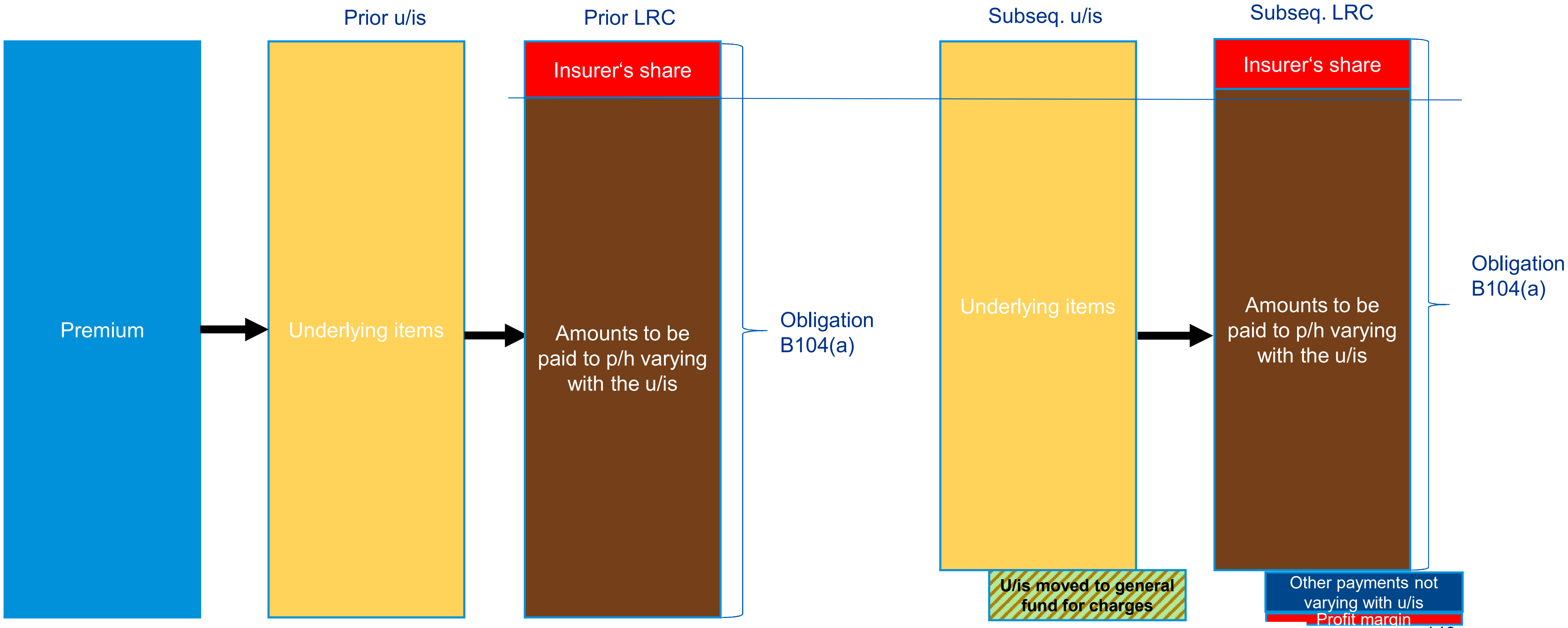




IFRS 17. B104(b)(i) Insurer' share and u/is: Charge by entity

The insurer withdraws a part of its share from the u/is as a charge for services like death coverage, taking cash out of the u/is.

That reduces the p/h's share in the u/is.



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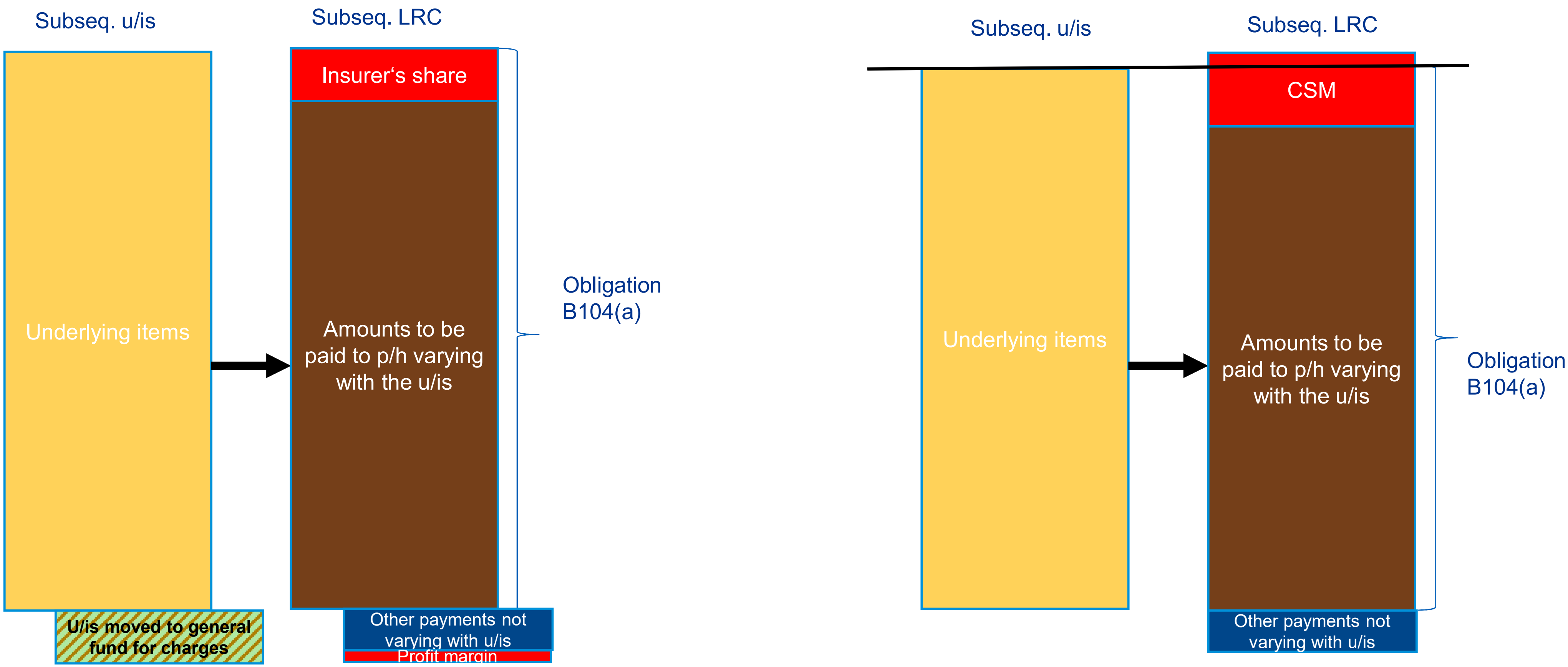
IFRS 17. B104(b)(i) Insurer' share and u/is: Charge by entity

Since as well the profit margin in the charge is withdrawn from the u/is, the corresponding CSM is no longer covered by the u/is.



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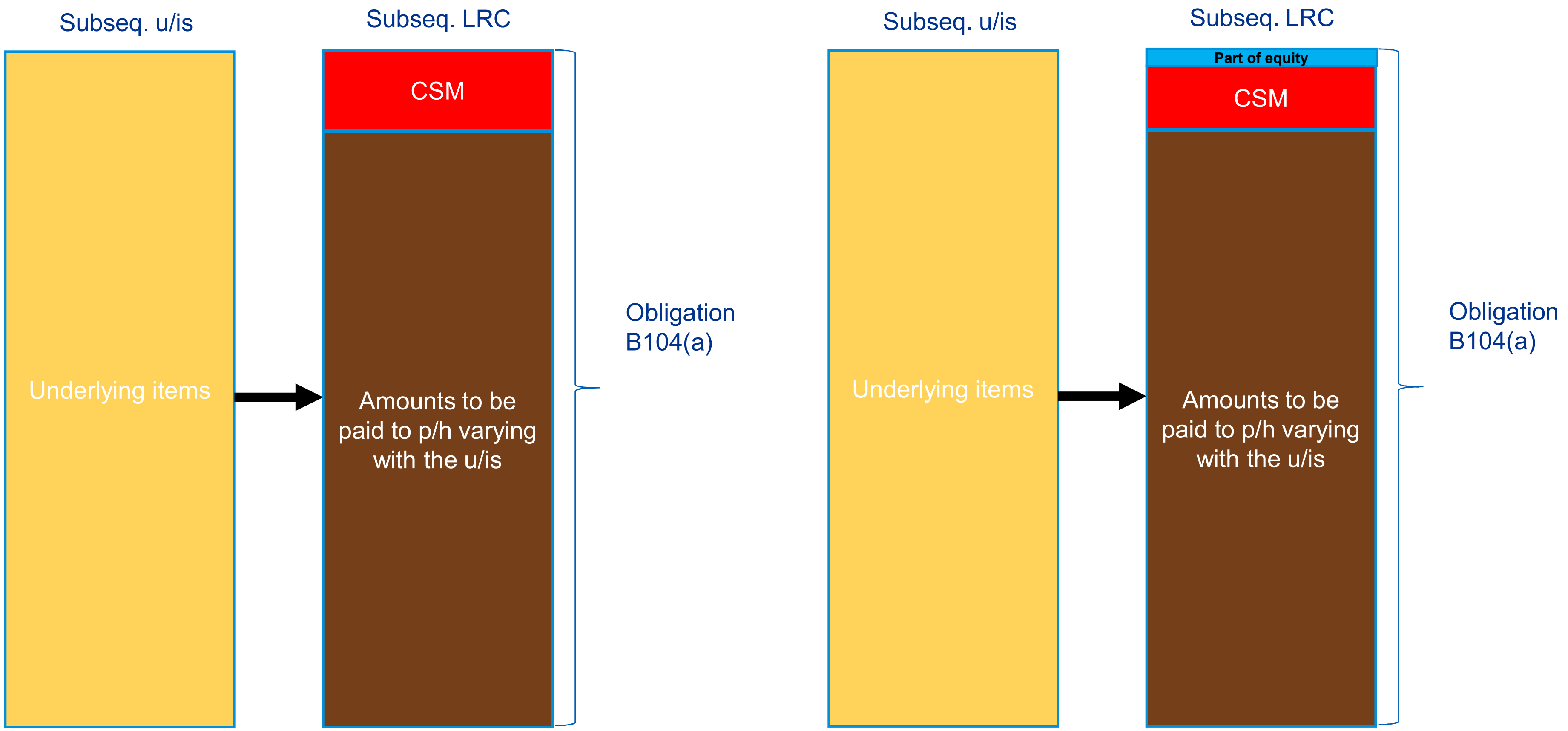
IFRS 17. B104(b)(i) Insurer' share and u/is: Release CSM

The systematic release of the CSM according to IFRS 17.45(e) need not to align with the movements of the u/is.

The CSM release is presented as insurance revenue and contributes to equity. Now, u/is cover as well a part of equity. Returns on equity are generated by the u/is and therefore shared with p/hs.

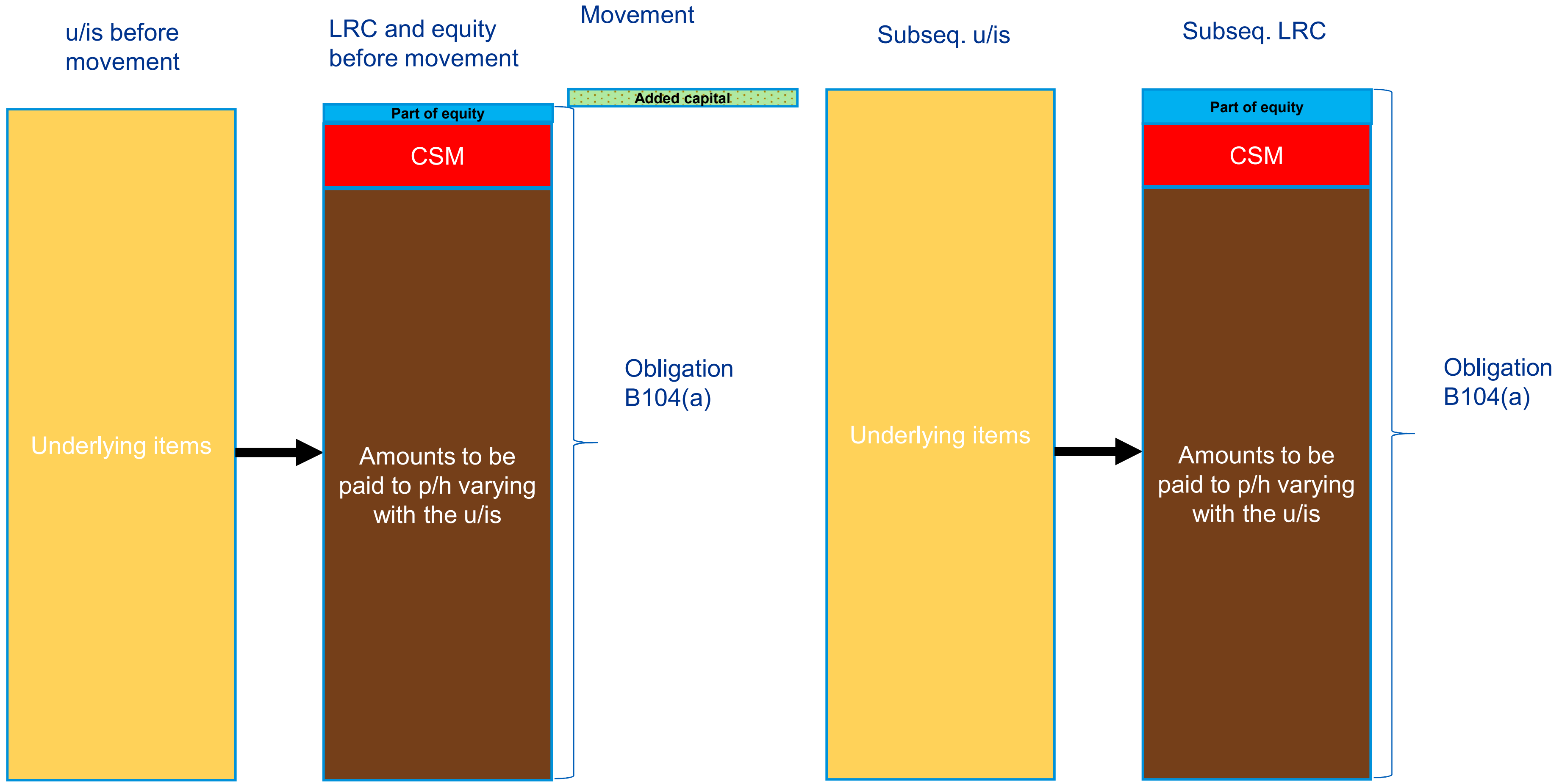
In some jurisdictions, without something like a „general fund", all assets of the entity are u/is and therefore the entire equity is covered by u/is.

The same applies e.g. if a part of the risk adjustment is released without withdrawing the money from the u/is. The insurance revenue results in equity covered by the u/is.



IFRS 17. B104(b)(i) Insurer' share and u/is: S/hs' subsidies

In some cases, the s/hs provide a capital contribution and the capital contribution, be it equity or funding of future benefits to p/hs is added to the u/is. By adding the capital to the u/is, they increase the obligation to the p/h under B104(a), i.e. returns generated have to be shared with p/h from now on.



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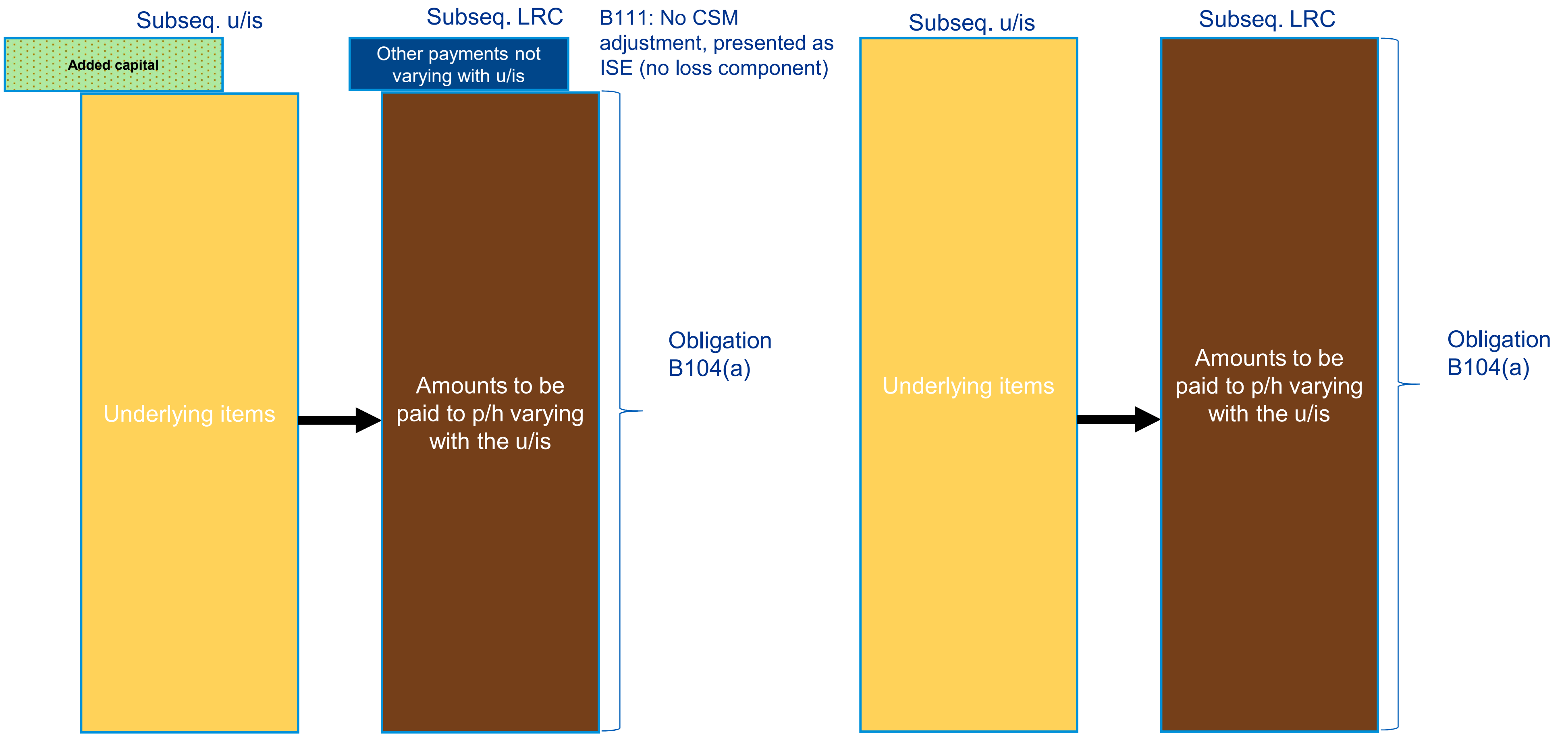
IFRS 17. B104(b)(i) Insurer' share and u/is: S/hs' subsidies

In some cases, the added capital is not corresponding with equity but is used to cover increases of amounts to be paid to p/hs since the contracts are onerous. Local law requires the addition of capital already in advance before the uncovered payments are due. They require that the subsidies are added to the u/is, with the consequence that the insurer does not only subsidizes the uncovered benefits but contributes further a share of the returns generated by the added amounts to the p/hs.

The excess benefits, which are not covered by u/is, where until capital contribution cash flows not varying with the u/is. The capital contribution causes that they are now covered by u/is and returns on the u/is increase to some extent as well those benefits.



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Explanation

- S/hs' subsidies added to the u/is do not adjust the CSM (B111) but the related (compensated) increase of the expected cash flows to p/hs are presented in ISE since they are simultaneous with an increase of the u/is.
  - They do not result in a loss component.
  - The transfer of ownership is completed when the amount is added to the u/is.
  - The fiction is that the s/hs paid premiums on behalf of the p/hs compensating for the additional benefits.
- Subsidies of the s/hs added to the u/is relate to that group whose cash flows changed triggering the need to top up the u/is.
  - In some cases, the s/hs provide subsidies to enhance the total participating benefits available for distribution, usually for competitive reasons. The entity will have, at that time, expectations which contracts will benefit from those amounts. As any other discretionary benefit, the subsidies are allocated to those contracts as if they were premiums off-setting the increase in benefits varying with u/is.

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IFRS 17.B119: CSM-Release

IFRS 17.B119: CSM release

- IFRS 17.B119 requires to release the CSM after all other movements of the period based on the relative volume of provision of insurance contract services in the period in relation to the overall remaining volume at begin of the period.
- The volume of insurance contracts services in a period is expressed by the quantity of benefits arising to the p/h from those services provided in the period, referred to as coverage unit of the period.
- Coverage units are relative measures determining a release pattern of the CSM.

Insurance contract services

- In case of direct participating contracts, the insurance contract services consist of
  - Insurance coverage services
    - Coverage for an insured event (not in case of investment contracts with discretionary participation features)
    - May consist of several separate coverage services
  - Investment-related services
    - The service provided by the insurer to the policyholder of managing the u/is (an activity otherwise to be proceeded by the policyholder).
    - To note: The service is the activity of managing the u/is, not the success of the activity. Bearing financial risks, e.g. bearing of minimum interest guarantees, is not a service but a financial transaction.

Deriving the coverage unit of a period

- The overall coverage unit of a period is to be determined for all those services together (ignoring any other service which might be provided under the contract).
  - The different services might be quantified separately and combined on a weighted basis.
  - Separate services may be quantified by starting from the question:
    - What is the quantity of the effort to be taken by the policyholder instead, if the service is not provided by the insurer?
      - Insurance coverage service: The policyholder would normally need to hold reserves covering the possible damages.
      - Investment-related service: The policyholder would need to manage the investment. The quantity of effort depends on the sophistication of the investment activity. E.g.
        - simply investing in the units of a defined mutual fund is merely a level quantity of effort.
        - investing in a well-diversified portfolio of assets is an activity whose quantity of effort may vary with the volume of the investments.

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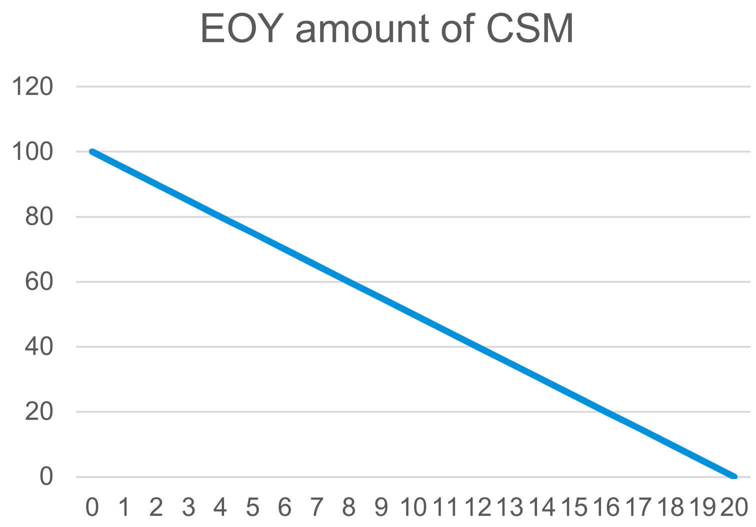
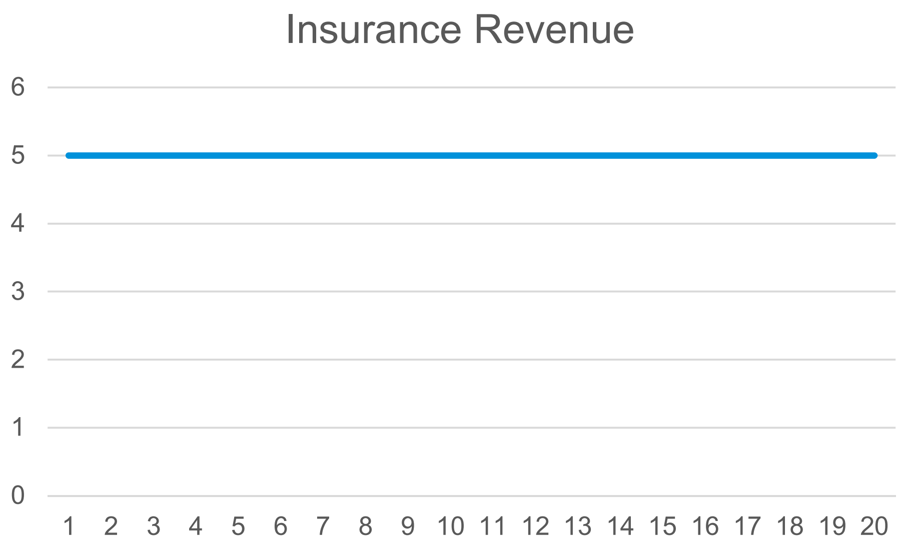
Deriving the release pattern

- IFRS 17.B119(b) can be read to require a release pattern strictly in proportion to the pattern of the coverage units of each period from the current to the last of the GIC.
- However, IFRS 17.BC282 clarifies that IFRS 17.B119(b) was not intended to be read a mathematical formula but that improvements are permissible, i.e. notably discounting of future coverage units in determining the release pattern for the general model.
- Without discounting the coverage units, the release pattern will not meet the objective of a release pattern in proportion to the service provided in each period, if the coverage period is relatively long and the interest to be accreted under the general model is quite high. Accordingly, IFRS 17.BC282 encourages in such cases to discount the coverage units.

IFRS 17's concept of CSM release

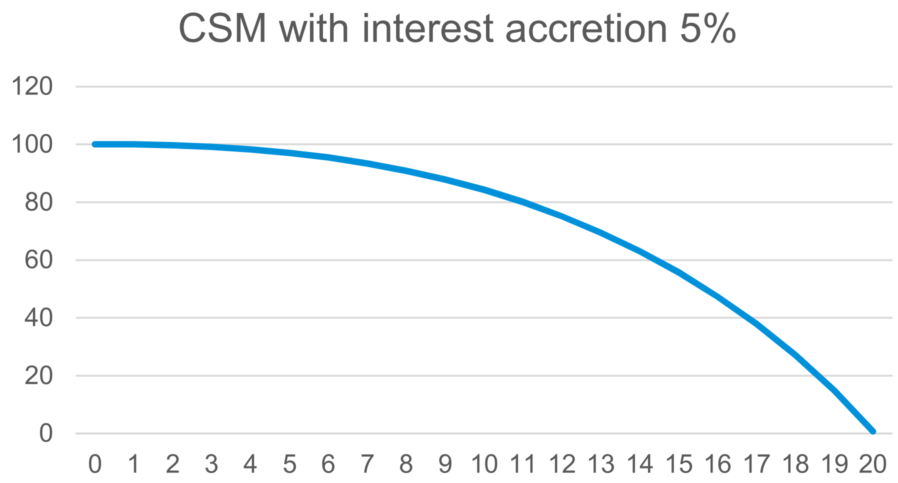
- The charts below show the systematic release of CSM of 100 CU over a coverage period of 20 years, assuming the constant provision of service over that period with accretion of zero interest on the CSM and no discounting of coverage units.
- The release pattern is in line with the objective to recognize insurance revenue in proportion to the service provided.

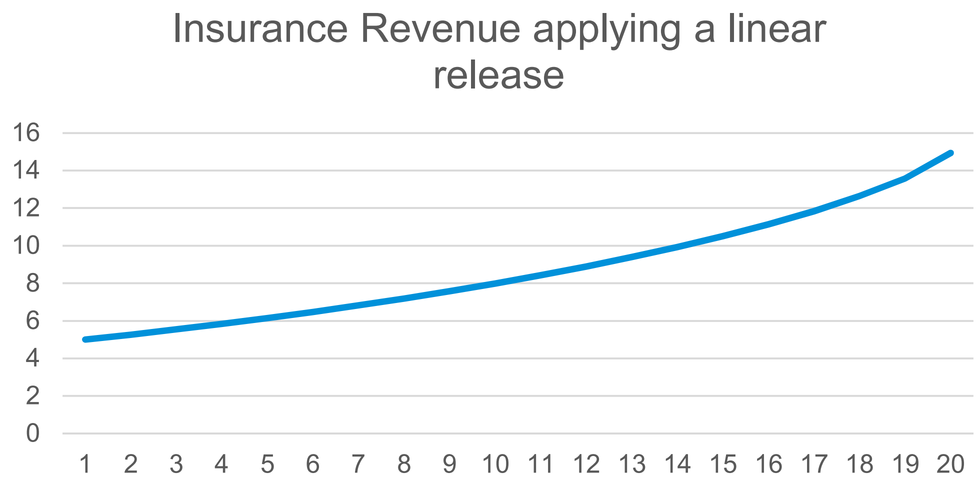




Systematic increase of CSM under General Model

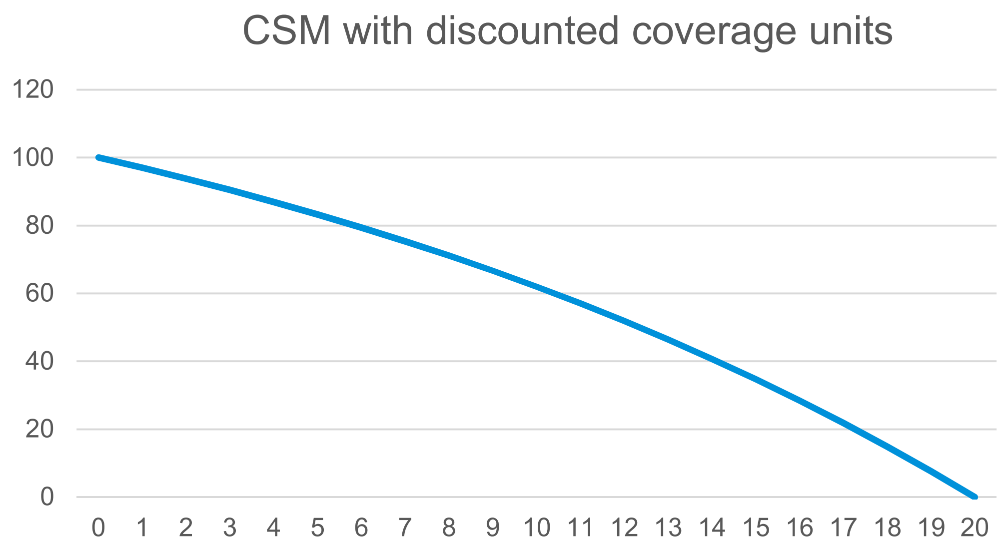
- The charts below show the CSM and release of insurance revenue for the same group of contracts assuming interest accretion on the CSM of 5% per annum.
- For a group of contracts where the remaining duration of the coverage period is k years, revenue is recognised as 1/k each year.
- If the CSM is released linearly in this way, based on coverage units without discounting, the CSM release increases systematically over the coverage period causing the so-called “bow wave effect” to insurance revenue.
- I.e., although the volume of service is level throughout, the insurance revenue recognized per period increases significantly.
- This violates the stated objective of IFRS 17.B119 sentence 1.

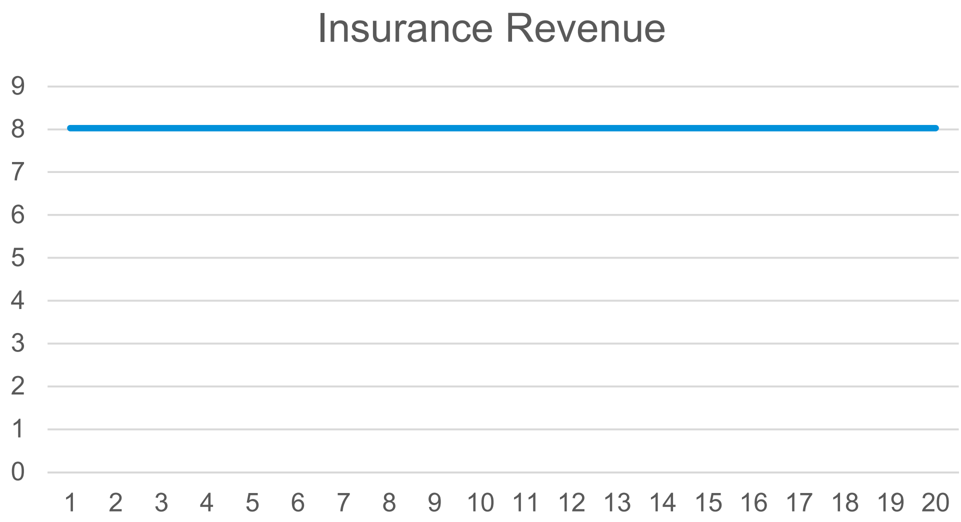




Solution in IFRS 17.BC282 for the General Model

- IFRS 17.BC282 notes that a discounted approach for determining the release pattern of coverage units is permissible, but that its application is a “matter of judgment“ for the entity. To note: Coverage units are quantities, not currency values, i.e. not money. There is accordingly no “time value of money” which could be applied to coverage units. Introducing discounting needs to have a deeper sense.
- It seems reasonable to assume that that judgement is to be applied with the aim to achieve the objectives of IFRS 17, i.e. the recognition of insurance revenue in line with the services provided.
- The chart below shows the development of the CSM over time assuming interest accretion of 5% and discounting coverage units to reflect the time value of money. Insurance revenue is released evenly over time eliminating the bow wave effect. Adjusting the coverage units with exactly the interest accreted on the CSM delivers the correct outcome, eliminating the systematic increasing effect of interest accretion on the CSM.



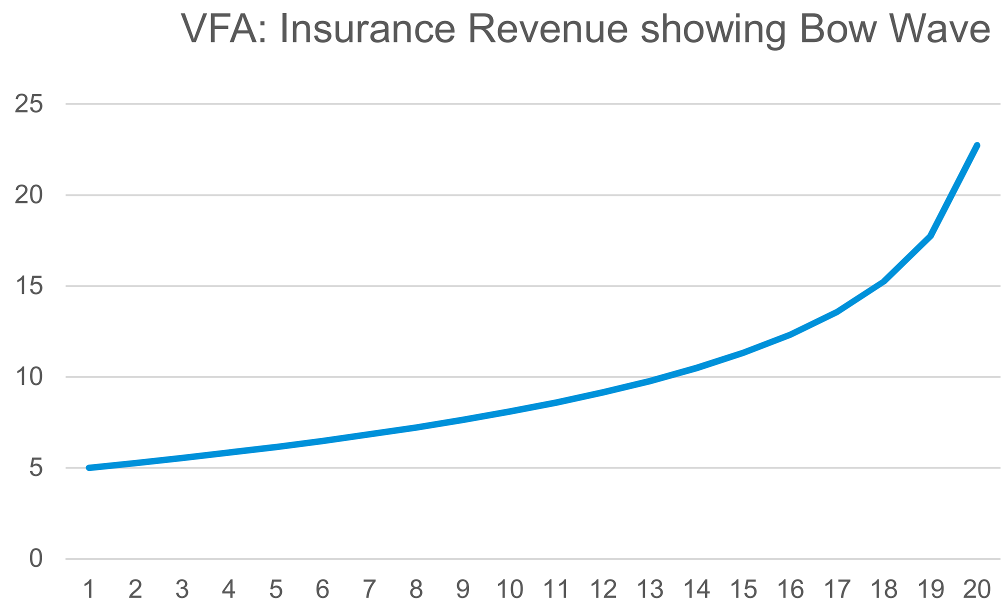


The bow wave effect and direct participating contracts

- The CSM for groups of direct participating contracts is adjusted for the insurer‘s share in differences between the unwind of the discount and the actual returns on the pool of underlying items applying IFRS 17.45(b) instead of accreting interest on the CSM as is the case for the general model (IFRS 17.44(b)).
- The CSM is determined at initial recognition and hence is risk-free, and financial risks are considered by means of adjustment to the CSM.
- IFRS 17.B74(b) permits both a risk-free and a real-world approach to discounting cash flows . However, if a real-world approach is applied, the insurer‘s share in any included financial risk needs to be eliminated by adjustments for financial risks, to ensure that the remaining CSM is risk-free.
- In practice a positive systematic difference arises in each period between real-world interest returns and the risk-free unwind of discount, adjusting the CSM in each period (IFRS 17.45(b)) respectively due to the release of the adjustment for financial risk if applying a real-world approach adjusting the CSM according to IFRS 17.B113(b).
- As a consequence, reflecting those systematic positive adjustments in any reporting period (all other adjustment represent deviations from the expected value, i.e. are expected to be neutral), IFRS 17.45(b) causes a systematic increase in the CSM which is equivalent to the accretion of interest according to IFRS 17.44(b).
- The insurer‘s share in the risk adjustment for financial risk on the pool of underlying items is typically much higher than the interest accreted on the CSM and the resulting effect (bow wave) is accordingly much more severe.

Illustrating the bow wave effect on direct par contracts

- Applying a straight line release of the CSM, as in slide 3, the amounts released from the CSM for a group of contracts accounted for using the VFA increase even more than in the General Model (see chart below which shows a steep increase in the amount released in later years of the coverage period).

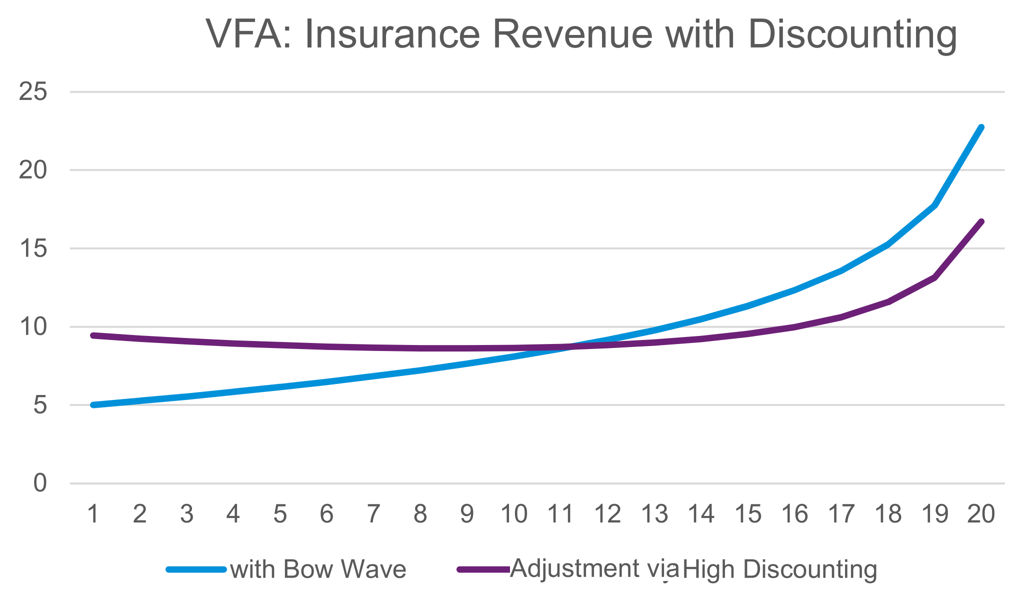


- The objective of IFRS 17 that the the entity recognises the profit from a group of insurance contracts over the period that the entity provides insurance contract services, reflecting the services provided in each period as the entity meets its obligation does not appear to be met by simply adding up coverage units in determining the release pattern.

Potential approaches to resolving the bow wave effect for direct participating contracts 1

Potential approach 1:

- Follow solution discussed in IFRS 17.BC282 by discounting coverage units.
- This is illustrated in the chart below with the release pattern from the preceding page shown in blue for comparison.



- This produces a release pattern that mitigates some of the bow wave effect but, even with an extremely high discount rate (here 20%, which is inacceptable as time value of money), still appears far away from common perceptions of the services provided in the period.

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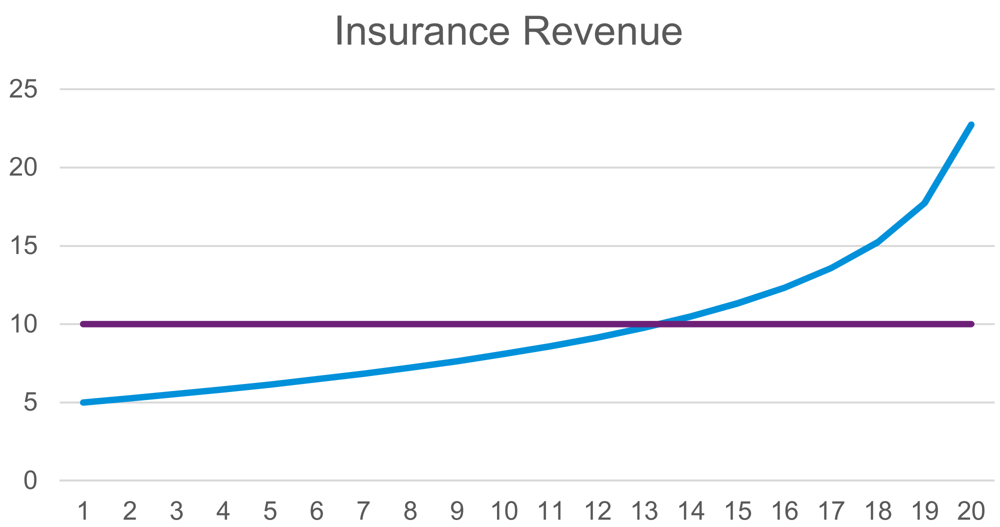
Potential approaches to resolving the bow wave effect for direct participating contracts 2

Potential approach 2

- Under the General Model IFRS 17.44(b) adds an amount to the CSM in each period (accretion of interest). It is this 'added amount' that causes the bow wave effect for general measurement model contracts.
- As we have seen, this effect can be mitigated for general measurement model contracts by considering the same adjustment to the coverage units in determining the equal allocation of the CSM remaining at the end of the reporting period to the coverage units provided in the period and the expected remaining coverage units. "Discounting" means to apply adjustments which reduce a future coverage unit in the applied formula as more as distant it is. The reduction equals the effect of the accretion of interest.
- A comparable approach for the VFA would be to reduce future coverage units as well in the extent as the adjustment systematically and expectedly increases the CSM, from both, the difference between risk-free and real world returns and the release of the adjustment for financial risk.



Alternatives

- The effect can technically be achieved by either
  - adjusting the coverage units itself by the systematic increase of the CSM in applying IFRS 17.B119(a) or
  - by determining the formula in IFRS 17.B119(b) in line with IFRS 17.BC282 in a way that it includes a reduction of the future coverage periods in summing them up.
- The adjustment to the release pattern has to be limited to a projected realistic systematic difference between the real world returns and the risk-free returns and the risk adjustments for financial risk included in the measurement. It is not permissible to apply adjustments based on actual differences between the risk-free unwind of discount of the current period and the actual incurred investment returns.