IFRS 17 issues – CSM allocation related to investment services

Amended draft for discussion

1 Current IASB requirements and TRG conclusions

1.1 IFRS 17 requirements

1 IFRS 17.44: For insurance contracts without direct participation features, the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for:

(a) the effect of any new contracts added to the group (see paragraph 28);

(b) interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates specified in paragraph B72(b);

(c) the changes in fulfilment cash flows relating to future service as specified in paragraphs B96–B100, except to the extent that:

(i) such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or

(ii) such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).

(d) the effect of any currency exchange differences on the contractual service margin; and

(e) the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph B119.

2 IFRS 17.45: For insurance contracts with direct participation features (see paragraphs B101–B118), the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for the amounts specified in subparagraphs (a)–(e) below. An entity is not required to identify these adjustments separately. Instead, a combined amount may be determined for some, or all, of the adjustments. The adjustments are:

(a) the effect of any new contracts added to the group (see paragraph 28);

(b) the entity's share of the change in the fair value of the underlying items (see paragraph B104(b)(i)), except to the extent that:

(i) paragraph B115 (on risk mitigation) applies;

(ii) the entity's share of a decrease in the fair value of the underlying items exceeds the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or

(iii) the entity's share of an increase in the fair value of the underlying items reverses the amount in (ii).

(c) the changes in fulfilment cash flows relating to future service, as specified in paragraphs B101–B118, except to the extent that:

(i) paragraph B115 (on risk mitigation) applies;

(ii) such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or

(iii) such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).

(d) the effect of any currency exchange differences arising on the contractual service margin; and

(e) the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period, applying paragraph B119.

3 IFRS 17.66: Instead of applying paragraph 44, an entity shall measure the contractual service margin at the end of the reporting period for a group of reinsurance contracts held as the carrying amount determined at the start of the reporting period, adjusted for:

(a) the effect of any new contracts added to the group (see paragraph 28);

(b) interest accreted on the carrying amount of the contractual service margin, measured at the discount rates specified in paragraph B72(b);

(c) changes in the fulfilment cash flows to the extent that the change:

(i) relates to future service; unless

(ii) the change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts.

(d) the effect of any currency exchange differences arising on the contractual service margin; and

(e) the amount recognised in profit or loss because of services received in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period of the group of reinsurance contracts held, applying paragraph B119.

4 IFRS 17.71: An investment contract with discretionary participation features does not include a transfer of significant insurance risk. Consequently, the requirements in IFRS 17 for insurance contracts are modified for investment contracts with discretionary participation features as follows:

(a) the date of initial recognition (see paragraph 25) is the date the entity becomes party to the contract.

(b) the contract boundary (see paragraph 34) is modified so that cash flows are within the contract boundary if they result from a substantive obligation of the entity to deliver cash at a present or future date. The entity has no substantive obligation to deliver cash if it has the practical ability to set a price for the promise to deliver the cash that fully reflects the amount of cash promised and related risks.

(c) the allocation of the contractual service margin (see paragraphs 44(e) and 45(e)) is modified so that the entity shall recognise the contractual service margin over the duration of the group of contracts in a systematic way that reflects the transfer of investment services under the contract.

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

6 IFRS 17.App A: investment component: The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

7 IFRS 17.B 65: Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:

(a) premiums (including premium adjustments and instalment premiums) from a policyholder and any additional cash flows that result from those premiums.

(b) payments to (or on behalf of) a policyholder, including claims that have already been reported but have not yet been paid (ie reported claims), incurred claims for events that have occurred but for which claims have not been reported and all future claims for which the entity has a substantive obligation (see paragraph 34).

(c) payments to (or on behalf of) a policyholder that vary depending on returns on underlying items.

(d) payments to (or on behalf of) a policyholder resulting from derivatives, for example, options and guarantees embedded in the contract, to the extent that those options and guarantees are not separated from the insurance contract (see paragraph 11(a)).

(e) an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.

(f) claim handling costs (ie the costs the entity will incur in investigating, processing and resolving claims under existing insurance contracts, including legal and loss-adjusters' fees and internal costs of investigating claims and processing claim payments).

(g) costs the entity will incur in providing contractual benefits paid in kind.

(h) policy administration and maintenance costs, such as costs of premium billing and handling policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract.

(i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.

(j) payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts.

(k) potential cash inflows from recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent that they do not qualify for recognition as separate assets, potential cash inflows from recoveries on past claims.

(l) an allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable to fulfilling insurance contracts. Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics.

(m) any other costs specifically chargeable to the policyholder under the terms of the contract.

8 IFRS 17.B 98: The terms of some insurance contracts without direct participation features give an entity discretion over the cash flows to be paid to policyholders. A change in the discretionary cash flows is regarded as relating to future service, and accordingly adjusts the contractual service margin. To determine how to identify a change in discretionary cash flows, an entity shall specify at inception of the contract the basis on which it expects to determine its commitment under the contract; for example, based on a fixed interest rate, or on returns that vary based on specified asset returns.

9 IFRS 17.B 119: An amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). The amount is determined by:

(a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.

(b) allocating the contractual service margin at the end of the period (before recognising any amounts in profit or loss to reflect the services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future.

(c) recognising in profit or loss the amount allocated to coverage units provided in the period.

10 IFRS 17.BC 222: The key service provided by insurance contracts is insurance coverage, but contracts may also provide investment-related or other services. The measurement of a group of insurance contracts at initial recognition includes a contractual service margin, which represents the margin the entity has charged for the services it provides in addition to bearing risk. The expected margin charged for bearing risk is represented by the risk adjustment for non-financial risk (see paragraphs BC206–BC214).

11 IFRS 17.BC 279: As discussed in paragraph BC21, the Board views the contractual service margin as depicting the unearned profit for coverage and other services provided over the coverage period. Insurance coverage is the defining service provided by insurance contracts. The Board noted that an entity provides this service over the whole of the coverage period, and not just when it incurs a claim. Consequently, IFRS 17 requires the contractual service margin to be recognised over the coverage period in a pattern that reflects the provision of coverage as required by the contract. To achieve this, the contractual service margin for a group of insurance contracts remaining (before any allocation) at the end of the reporting period is allocated over the coverage provided in the current period and expected remaining future coverage, on the basis of coverage units, reflecting the expected duration and quantity of benefits provided by contracts in the group. The Board considered whether:

(a) the contractual service margin should be allocated based on the pattern of expected cash flows or on the change in the risk adjustment for non-financial risk caused by the release of risk. However, the Board decided the pattern of expected cash flows and the release of the risk adjustment for non-financial risk are not relevant factors in determining the satisfaction of the performance obligation of the entity. They are already included in the measurement of the fulfilment cash flows and do not need to be considered in the allocation of the contractual service margin. Hence, the Board concluded that coverage units better reflect the provision of insurance coverage.

(b) the contractual service margin should be allocated before any adjustments made because of changes in fulfilment cash flows that relate to future service. However, the Board concluded that allocating the amount of the contractual service margin adjusted for the most up-to-date assumptions provides the most relevant information about the profit earned from service provided in the period and the profit to be earned in the future from future service.

12 IFRS 17.BC 280: The Board considered whether the allocation of the contractual service margin based on coverage units would result in profit being recognised too early for insurance contracts with fees determined based on the returns on underlying items. For such contracts, IFRS 17 requires the contractual service margin to be determined based on the total expected fee over the duration of

the contracts, including expectations of an increase in the fee because of an increase in underlying items arising from investment returns and additional policyholder contributions over time. The Board rejected the view that the allocation based on coverage units results in premature profit recognition. The Board noted that the investment component of such contracts is accounted for as part of the insurance contract only when the cash flows from the investment component and from insurance and other services are highly interrelated and hence cannot be accounted for as distinct components. In such circumstances, the entity provides multiple services in return for an expected fee based on the expected duration of contracts, and the Board concluded the entity should recognise that fee over the coverage period as the insurance services are provided, not when the returns on the underlying items occur.

1.2 TRG

13 TRG 2018-05 AP 5.38: […] The staff plan to recommend to the Board that it proposes a narrow amendment to IFRS 17 to modify the definition of coverage period for VFA contracts to clarify that it includes the period in which investment-related services are provided.

14 TRG 2018-05 AP 5.41: In contrast to the VFA, the staff observe the general model in IFRS 17 does not treat contracts as providing investment-related services. […]

15 TRG 2018-05 AP 5.42: […] IFRS 17 uses the scope of the VFA to identify insurance contracts that provide investment-related services as well as insurance services. For contracts outside the scope of the VFA, there is not a sufficient link between the amounts promised to policyholders and the returns on assets for the entity to receive a fee from the policyholder for investment-related services. Instead, the assets arising from the premiums received are the entity's assets that it manages on its own behalf. The amounts promised to policyholders other than insurance benefits (ie the investment components) are not related to service, but are instead a form of financial instrument. The difference between the investment income from the entity's assets and insurance finance expenses is presented as a finance result.

16 TRG 2018-05 Summary.39: Most TRG members disagreed that insurance contracts under the general model should be treated as providing only insurance services.

17 TRG 2019-04 Summary AP 1.7(a): […] an investment component is defined in Appendix A of IFRS 17 as the amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur. Paragraph BC34 of the Basis for Conclusions on IFRS 17 explains that an investment component is an amount that is paid to the policyholder in all circumstances. The staff noted the recommendation in Agenda Paper 2D Annual improvements for the April 2019 Board meeting that the **Board propose an annual improvement to that definition to better reflect the Board's intention and to include explicitly the requirement that an investment component is the amounts**

that an insurance contract requires the entity to repay to a policyholder *in all circumstances*.

1.3 Tentative Board's decisions

June 2018 meeting

18 IASB 2018-06 AP 2B § 9: The Board acknowledges that some insurance contracts provide services other than insurance coverage: paragraph BC222 of the Basis for Conclusions on IFRS 17 states 'The key service provided by insurance contracts is insurance coverage, but contracts may also provide investment-related or other services'. However, BC279 of the Basis for Conclusions on IFRS 17 observes 'Insurance coverage is the defining service provided by insurance contracts'. The focus in these statements on insurance coverage reflects the fact that contracts are in the scope of IFRS 17 because they provide insurance coverage.

19 IASB 2018-06 AP 2B § 10: In determining coverage units, IFRS 17 requires an entity to assess the services provided to the policyholder. For general model contracts, the Board decided that useful information is provided by recognising the contractual service margin in profit or loss over the period in which insurance coverage is provided. Not considering any other service avoids complexity and subjective or arbitrary allocations, and reflects the key service of insurance. The Board decided a different approach to reflect the effect of investment-related services was appropriate only for those contracts that fall within the scope of the variable fee approach (see discussion in paragraphs 13–16 of this paper).

20 Suggested amendments would be as follows:

21 IFRS 17.App A: coverage period: For insurance contracts without direct participation features ~~The~~ period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract. For insurance contracts with direct participation features, the period during which the entity provides coverage for insured events or investment-related services. This period includes the coverage for insured events or investment-related services that relate~~s~~ to all premiums within the boundary of the insurance contract.

22 IFRS 17.B 119: An amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). The amount is determined by:

(a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage period ~~duration~~.

January 2019 meeting

23 IASB 2019-01 AP 2E § 27: The staff think it is possible to justify the recognition of the contractual service margin over a period that includes the period in which the policyholder gets a return, even when this extends beyond the period when insurance coverage is provided, on the grounds that the entity is providing a service in that period. **The service is** not an asset management service because the entity is not managing assets on behalf of the policyholders. Rather it is **providing the policyholder with access to an investment return that would not otherwise be available to the policyholder because of the amounts invested, liquidity, complexity and expertise**. The staff use the term 'investment return service' for this service.

24 IASB 2019-01 AP 2E § 45: Some stakeholders have questioned whether the costs of managing assets that form underlying items for insurance contracts can be included in the fulfilment cash flows for the contracts, both for variable fee contracts and for general model contracts.

25 IASB 2019-01 AP 2E § 46: The staff observe that IFRS 17 includes in the fulfilment cash flows those cash flows that relate directly to the fulfilment of the contract, including an allocation of fixed and variable overheads directly attributable to fulfilling insurance contracts. For variable fee contracts, where the policyholder is regarded as investing in assets that the entity manages on its behalf, it follows that the asset management costs should be regarded as part of the costs of fulfilling the contracts. Hence, they will be included in the fulfilment cash flows. Further, the staff think that to the extent that an entity includes an investment return service for general model contracts in the determination of coverage units, it should also include cash flows related to the fulfilment of that service in the fulfilment cash flows.

26 The Board tentatively decided:

- a.to amend IFRS 17 so that in the general model the contractual service margin is recognised in profit or loss on the basis of coverage units that are determined by considering both insurance coverage and investment return service, if any;
- b.to amend IFRS 17 to establish that **an investment return service exists only when an insurance contract includes an investment component**;
- c.to amend IFRS 17 to require an entity to use judgement applied consistently in deciding whether an investment return service exists when determining coverage units, and not provide an objective or criteria for that determination. However, the Board instructed the staff to consider including in the Basis for Conclusions some of the analysis in the Board paper, to indicate what such judgements might involve;
- d.to amend IFRS 17 to establish that the period of investment return services should be regarded as ending when the entity has made all investment component payments to the policyholder of the contract and should not include any period of payments to future policyholders;
- e.to amend IFRS 17 to require assessments of the relative weighting of the benefits provided by insurance coverage and investment return services and their pattern of delivery to be made on a systematic and rational basis;
- f.to confirm that, applying IFRS 17, cash flows relating to fulfilling the investment return service are included in the measurement of the insurance contract;

- g.not to change the requirements of IFRS 17 relating to changes in fulfilment cash flows that adjust the contractual service margin in the general model; and
- h.to amend IFRS 17 to establish that the one-year eligibility criterion for the PAA should be assessed by considering insurance coverage and an investment return service, if any.

April 2019 meeting

27 IASB 2019-04 AP 2D § 11: Amendment to clarify the definition of an investment component. IFRS 17 defines an investment component as the amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur. Paragraph BC34 of the Basis for Conclusions on IFRS 17 explains that an investment component is an amount that is paid to the policyholder in all circumstances. That explanation is not entirely captured by the wording of the definition. For example, a contract may require the entity to pay an amount to the policyholder if the policyholder surrenders a contract during the coverage period. However, no amount is payable to the policyholder if the contract continues to the end of the coverage period without a claim being made. If the policyholder surrenders the contract, a payment is made even if an insured event does not occur. It was not the Board's intention that such a contract should be regarded as including an investment component. The recommended amendment clarifies the definition to achieve the Board's intention.

28 Suggested amendment to IFRS 17.App A: investment component: The amounts that an insurance contract requires the entity to repay to a policyholder ~~even if an insured event does not occur~~ in all circumstances..

1.4 Current understanding of the accounting treatment

29 The standard does not provide a definition of "coverage" or "investment return service".

30 The CSM for investment contracts is recognised over a period including the investment related service period. IFRS 17.71(c) explicitly mentions that investment contracts with discretionary participation features:

- shall recognise the contractual service margin over the duration of the group of contracts in a systematic way that reflects the transfer of investment services under the contract
- have "modified" requirements, as compared to the general model

31 The reference made to a "modification" to the general model highlights *a contrario* that such investment services might not be reflected in the general model.

32 Considering investment services in the allocation of the CSM in any kind of insurance contract is not explicitly precluded, but the point remains unclear (as acknowledged in the TRG 2018-05 AP 5 §38 referring to the last sentence of IFRS 17.BC 280 which can be read restrictively).

33 At its June 2018 meeting, the Board tentatively decided to clarify that the coverage period for VFA contracts includes periods in which the entity provides investment-related services. *A contrario* such periods would not be included in contracts under the general model.

34 In January 2019, IASB Board tentatively decided to amend IFRS 17 so that in the general model the contractual service margin is recognised in profit or loss on the basis of coverage units that are determined by considering both insurance coverage and investment-return service. An investment return service would only exist when the insurance contract includes an investment component.

35 In April 2019, IASB Board tentatively decided to clarify that an investment component is the amounts that an insurance contract requires the entity to repay to a policyholder in *all* circumstances.

2 Issue

2.1 VFA contracts are not the only ones to provide investment services

36 Investment-return services are not an accounting feature that is used for defining accounting types of insurance contracts in the standard. If participating contracts generally provide investment-return services, not all do.

37 Moreover investment services can be included in contracts with and without investment components and investment components can be repaid with or without being connected with investment services.

38 Examples of non-VFA contracts providing investment-return services have been mentioned in the EFRAG's case study:

- Contracts where premiums are held in an interest bearing deposit for an extended time before coverage commences (e.g. some forms of deferred annuities)
- Reinsurance contracts (currently not eligible to the VFA) where the underlying contracts are VFA contracts (e.g. Préfon).

39 The allocation period of the CSM should therefore be extended to the longest period including the investment phase. The latter may be prior (i.e. annuities) or after (life insurance with accumulated benefits) the insurance phase.

40 We therefore support the IASB's tentative decision to

- explicitly take into consideration "investment-related/return" services as well as the suggested definition;
- not restrict the consideration of such services to VFA contracts;
- not require a split of the CSM between those two components (that would otherwise have added another level of disaggregation in the current grouping requirements).

2.2 Existence of the service depending upon an "investment component"

41 In the March 2019 meeting, IASB tentatively restricted the existence of investment-return services when the insurance contract includes an "investment component". Furthermore, IASB has confirmed the definition of an investment component as being "the amounts that an insurance contract requires the entity to repay to a policyholder in all circumstances".

42 Based on the example of a deferred annuity that includes small or no investment component, following questions have been raised at EFRAG regarding the new requirements:

- When the insurance service is not (priced) the same if underwritten at the end of the accumulation period (compared with at inception), this demonstrates the time value progressively gained by the option offered to the survivors having initially contracted. Such an option could be considered as a genuine insurance service (if not as an investment service).
- Are costs incurred in managing the assets during the accumulation period belonging to the FCF (and then consistently recognised with the corresponding revenue)? IASB already acknowledged in its tentative decision in January 2019 (IASB 2019-01.AP 2E §45-46) that such costs belong to the FCF if VFA is applied or in the general model "to the extent that an entity includes an investment return service". More broadly, applying IFRS 17.B 65(m), wouldn't such costs belong to the FCF as long as they relate to a service provided (being investment return or insurance)?

3 Suggested solution (tentative)

3.1 Discussion

43 We suggest extending the definition of the coverage period in order to take into consideration investment-return services. Assuming such an extension, since IFSR 17.B 119 applies to all contracts, this should be sufficient, subject to a minor clarification, to extend the possibility to consider investment-return services for any contract and not only to VFA contracts.

44 Since “investment-return services” are not defined in the standard, there is a risk of limiting that feature to certain types of contracts. We therefore suggest making sure and clarifying such services are broadly understood, regardless of their IFRS 17 classification.

3.2 Suggested solution

45 IFRS 17.App A: **coverage period:** The period during which the entity provides coverage for insured events and/or investment-return services. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.

46 IFRS 17.App A: **investment-return service:** is the service providing the policyholder with access to an investment return that would not otherwise be available to the policyholder because of the amounts invested, liquidity, complexity and expertise.

47 IFRS 17.B 119: An amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). The amount is determined by:

(a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage for insured events and/or of investment-return services provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage period ~~duration~~.