Liberté • Égalité • Fraternité
RÉPUBLIQUE FRANÇAISE

AUTORITE DES NORMES COMPTABLES
5, PLACE DES VINS DE FRANCE
75573 PARIS CÉDEX 12
Phone (+ 33 1) 53.44.28 53
Internet http://www.anc.gouv.fr/
Mel patrick.de-cambourg@anc.gouv.fr
Chairman

PDC N° 05

Paris, January 16th , 2019

Mr Hans HOOGERVORST
IASB Chair
7 Westferry Circus, Canary Wharf
LONDON, UK, E14 4HD

Dear Hans,

As mentioned in my letter dated November 12th 2018 and during our various contacts, ANC is working on a number of concerns related to IFRS 17, in particular those raised by EFRAG early September.

We are pleased to share with you a second group of two documents concerning, in no particular order of priority: the reinsurance contracts and the contractual service margin.

As for the first group of three documents we already sent you, these documents will be shared with our Board and with EFRAG and we have given them the status of "draft for discussion" since the matters addressed are very complex and may require additional exchanges of views.

We remain at your disposal should you wish to share with us your observations.

Yours sincerely, Kind regards.

Patrick de Cambourg

Patrick de CAMBOURG

IFRS 17 issues – Reinsurance

Draft for discussion

1 Current IASB requirements and TRG conclusions

1.1 IFRS 17 requirements

1 IFRS 17.47: An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognised acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow. Applying paragraph 16(a), an entity shall group such contracts separately from contracts that are not onerous. To the extent that paragraph 17 applies, an entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts. An entity shall recognise a loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero.

2 IFRS 17.60: The requirements in IFRS 17 are modified for reinsurance contracts held, as set out in paragraphs 61–70.

3 IFRS 17.61: An entity shall divide portfolios of reinsurance contracts held applying paragraphs 14–24, except that the references to onerous contracts in those paragraphs shall be replaced with a reference to contracts on which there is a net gain on initial recognition. For some reinsurance contracts held, applying paragraphs 14–24 will result in a group that comprises a single contract.

4 IFRS 17.62: Instead of applying paragraph 25, an entity shall recognise a group of reinsurance contracts held:

(a) if the reinsurance contracts held provide proportionate coverage—at the beginning of the coverage period of the group of reinsurance contracts held or at the initial recognition of any underlying contract, whichever is the later; and

(b) in all other cases—from the beginning of the coverage period of the group of reinsurance contracts held.

5 IFRS 17.63: In applying the measurement requirements of paragraphs 32–36 to reinsurance contracts held, to the extent that the underlying contracts are also measured applying those paragraphs, the entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

6 IFRS 17.64: Instead of applying paragraph 37, an entity shall determine the risk adjustment for non-financial risk so that it represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.

7 IFRS 17.65: The requirements of paragraph 38 that relate to determining the contractual service margin on initial recognition are modified to reflect the fact that for a group of reinsurance contracts held there is no unearned profit but instead a net cost or net gain on purchasing the reinsurance. Hence, on initial recognition:

(a) the entity shall recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of the fulfilment cash flows, the amount derecognised at that date of any asset or liability previously recognised for cash flows related to the group of reinsurance contracts held, and any cash flows arising at that date; unless

(b) the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, in which case, notwithstanding the requirements of paragraph B5, the entity shall recognise such a cost immediately in profit or loss as an expense.

8 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.

9 IFRS 17.67: Changes in the fulfilment cash flows that result from changes in the risk of non-performance by the issuer of a reinsurance contract held do not relate to future service and shall not adjust the contractual service margin.

10 IFRS 17.68: Reinsurance contracts held cannot be onerous. Accordingly, the requirements of paragraphs 47–52 do not apply.

11 IFRS 17.69: An entity may use the premium allocation approach set out in paragraphs 55–56 and 59 (adapted to reflect the features of

reinsurance contracts held that differ from insurance contracts issued, for example the generation of expenses or reduction in expenses rather than revenue) to simplify the measurement of a group of reinsurance contracts held, if at the inception of the group:

(a) the entity reasonably expects the resulting measurement would not differ materially from the result of applying the requirements in paragraphs 63–68; or

(b) the coverage period of each contract in the group of reinsurance contracts held (including coverage from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less.

12 IFRS 17.70: An entity cannot meet the condition in paragraph 69(a) if, at the inception of the group, an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the asset for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:

(a) the extent of future cash flows relating to any derivatives embedded in the contracts; and

(b) the length of the coverage period of the group of reinsurance contracts held.

13 IFRS 17.82: An entity shall present income or expenses from reinsurance contracts held separately from the expenses or income from insurance contracts issued.

14 IFRS 17.86: An entity may present the income or expenses from a group of reinsurance contracts held (see paragraphs 60–70), other than insurance finance income or expenses, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount. If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid, it shall:

(a) treat reinsurance cash flows that are contingent on claims on the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract held;

(b) treat amounts from the reinsurer that it expects to receive that are not contingent on claims of the underlying contracts (for example, some types of ceding commissions) as a reduction in the premiums to be paid to the reinsurer; and

(c) not present the allocation of premiums paid as a reduction in revenue.

15 IFRS 17.App.A: reinsurance contract: An insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts).

16 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.

17 IFRS 17.B 101: 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. Hence, they are defined as insurance contracts for which:

(a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items (see paragraphs B105–B106);

(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 (see paragraph B107); 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 (see paragraph B107).

18 IFRS 17.B 109: Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of IFRS 17.

19 IFRS 17.BC 241; IFRS 17.BC 248-249; IFRS 17.BC 296-BC 315 are further detailed in Appendix 2: Bases for conclusions.

1.2 TRG

<u>TRG Staff analysis (2018-02 AP 03 and summary): reinsurance contract's boundaries</u>

20 When discussing the boundaries of reinsurance contracts held applying IFRS 17.34, IASB staff pointed out that:

- The postponement of the initial recognition date for proportionate reinsurance is not relevant with regards to measurement requirements and was only granted as a practical expedient;
- The consistency requirement with the assumptions of underlying contracts only applies to contracts already written ("to the extent that they are measured applying").

21 There was a broad consensus among TRG members that such contracts boundaries would not faithfully depict the contractual rights and obligations from the reinsurance contracts and would raise operational complexity (§16(b)).

<u>TRG Staff analysis (2018-09 AP 03): presentation in the reinsurer's statement of performance (2018-09 Summary)</u>

22 Since IFRS 17.86 only addresses reinsurance contracts held, the TRG has been asked to address presentation issues in the statement of financial performance of a reinsurer regarding amounts exchanged with the primary insurer and concluded that:

- Amounts exchanged that are <u>not</u> contingent on claims are equivalent to the effect of charging a different premium (~insurance revenue or investment component if repaid to the cedant in all circumstances);
- Amounts exchanged that are contingent on claims are equivalent to reimbursing a different amount of claims than expected (~insurance expense);
- Unless the cedant provides a distinct service to the reinsurer that results in a cost to the reinsurer for selling, underwriting and starting a group of reinsurance

contracts that it issues, a ceding commission is not an insurance acquisition cash flow of the reinsurer.

– amounts exchanged between the reinsurer and the cedant that are not contingent on claims may meet the definition of an investment component if they are repaid to the cedant in all circumstances (including on cancellation of the contract) [2018-09 Summary § 14(e)]

<u>TRG staff analysis on reinsurance vs. co-insurance or transfer of insurance contracts (2018-09 AP 09 and 2018-09 Summary)</u>

23 According to the definition in appendix A, a reinsurance contract is an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts).

24 Co-insurance contracts are not defined in the standard but have been addressed by the TRG (TRG 2018-09.AP 09.18 and 2018-09 Summary § 33(b)) when dealing with "insurance contracts issued by more than one entity". Such contracts are either in the scope of IFRS 11 or, as no other standard applies, a specific accounting policy may be developed according to IAS 8.10.

25 The TRG also contemplated the case when an entity writes a contract and then subsequently transfers it. The transfer may then either (i) meet the definition of a reinsurance contract or (ii) extinguish the entity's obligation to the policyholder, applying IFRS 17.74. (TRG 2018-09.AP 09.22 and 2018-09 Summary § 33(c))

1.3 Current understanding of the accounting treatment

<u>Accounting treatment of reinsurance contracts issued</u>

26 The standard does not address separately reinsurance contracts issued: they are treated similarly to insurance contracts (IFRS 17.BC 296) except for IFRS 17.B 109 that explicitly prohibits applying the VFA.

27 The standard prohibits the application of the VFA to reinsurance contracts issued even when meeting the criteria (IFRS 17.BC 249). The reason provided is that a reinsurer cannot receive a "fee" depicted in BC 241 as the returns on a pool of underlying items being part of a compensation that it charges for the service provided to policyholders.

28 In the statement of financial performance of a reinsurer, the presentation of amounts exchanged with the primary insurer is not addressed by the standard. TRG suggests presentation rules (rather than principles requiring judgement) that are based on the relation to the amount of claim rather than on the nature of the service received or provided.

<u>Accounting treatment of reinsurance contracts held</u>

29 According to IFRS 17, reinsurance contracts have to be accounted for as separate contracts, i.e. not as an element of the cash-flows of the underlying insurance contracts. As a consequence, even if reinsurance contracts may have an impact of the profitability of underlying insurance contracts, they have no impact on the level of aggregation applied on the underlying contracts.

30 Reinsurance contracts held are subject to the general standard's provisions with some adjustment expressed in IFRS 17.60-70. Such adjustments have been reflected in Appendix 1: application of specific provisions on reinsurance contracts held (IFRS 17.60-.70). This simulation makes it clear that the specific provisions on

reinsurance contracts held are not literally transposable into the general requirements of the standard on insurance contracts. Among others, we stress the point that:

– Level of aggregation requirements relating to onerous contracts (or contracts that may become onerous) are incompatible with IFRS 17.68 stating that reinsurance contracts cannot be onerous. In addition, the modifications to IFRS 17.14 to 24 required by IFRS 17.61 introducing the notion of “contracts on which there is a net gain on initial recognition” do not seem to create the conditions for an sdequate aggregation of reinsurance contracts held.
– General provisions on subsequent measurement (IFRS 17.40-43) refer to liabilities and unearned profits and therefore cannot apply without further adjustments to reinsurance contracts held.

31 A “bouquet” of reinsurance treaties combines a set of reinsurance contracts between the same primary insurer and the same reinsurer, as addressed in principle by IFRS 17.9. The standard acknowledges that it may be necessary to treat the series of contracts as a whole. In order to apply the provisions on the level of aggregation in IFRS 17.14, the entity would apply IFRS 17.24 and allocate the fulfilment cash-flows of the bouquet to each separate portfolio. Such a bouquet may raise application issues (but no standard-setting issue) regarding the level of aggregation of reinsurance contracts held and the allocation of the CSM to the portfolios and groups.

32 The net gain on reinsurance contracts held on initial recognition has to be spread over the duration of the reinsurance contract, even if it efficiently covers onerous insurance contracts issued, which losses have been immediately recognised; [IFRS 17.61 and IFRS 17.65(a)]

33 IFRS 17.B 109 prohibits the application of VFA to reinsurance contracts held.

2 Issue

2.1 Nature of reinsurance contracts

34 From the perspective of the (ceding) primary insurer, reinsurance held (ceded/purchased) is an efficient risk mitigating tool because reinsurers benefit from higher diversification effects, i.e. a lower risk adjustment.

35 Reinsurance on an annual or multi-year basis may be:

– Proportional treaties (including “surplus-share” or “quota-share”, covering losses on a proportional basis); or
– Non-proportional treaties (“excess of loss”, covering aggregate losses in excess of a specified amount).

36 The proper accounting treatment of reinsurance held from the perspective of the primary insurer should, in principle:

– be driven by the economic link between the reinsured business and the reinsurance transaction, rather than by the form of the reinsurance transaction.
– present the risk mitigation effects of reinsurance held in symmetry with the accounting performance of the reinsured business.

<u>Reported issues</u>

37 Several issues have been reported:

38 1. Reinsurance issued or held cannot be accounted for under the VFA model, even if the VFA model is applied to the underlying insurance contracts;

39 2. For a contract onerous on initial recognition an insurer has to recognise a loss component though P/L whereas the relief from a corresponding reinsurance contract held has to be deferred and recognised over the coverage period;

40 3. Contract boundaries for reinsurance may be inconsistent with those of the underlying insurance contracts; indeed reinsurance accounting results in including an estimate of underlying insurance business that is not yet written/recognised;

41 4. Specific presentation issues in the statement of financial performance of a reinsurer.

2.2 Prohibition of VFA to reinsurance contracts

42 As mentioned above (§ 27 and § 33), the dedicated accounting treatment (”VFA”) for direct participating contracts does not apply to reinsurance contracts issued or held. Stakeholders in certain jurisdictions have identified direct participating contracts (that can be managed in substance as co-insurance business) that would meet the specific VFA criteria in the standard and question the conceptual reasons for such a prohibition.

<u>Reinsurance contracts with direct participation features</u>

43 Non-proportional treaties generally do not cover financial risks. By contrast, some proportional (or “quota-share”) treaties do actually “share the returns on the underlying items between the primary insurer and the reinsurer”. Such reinsurance contracts are proportionally exposed to the same underlying risks and returns as the primary insurance contracts. Such treaties are generally set:

- for business purposes, e.g. exchanging reinsurance service against access to a broader distribution network. In order to provide a broader service but keeping the direct commercial relationship with the policyholder, an insurer may hold reinsurance contracts ;
- in order to provide a better performance to the policyholder when combining the performance of several insurers;
- to achieve prudential solvency capital requirements, such prudential ratio being computed net of reinsurance contracts.

44 “Quota-share” reinsurance contracts with direct participation features have in common that:

- a pool of underlying items is shared between the reinsurer and the primary insurer;
- the reinsurer’s obligations towards the primary insurer replicate the primary insurer’s obligations towards policyholders:
    - the reinsurer has to pay a significant part of the returns of the share of the underlying items it holds to the primary insurer so that the latter may pay them to the primary policyholders;
    - a substantial proportion of the cash flows the reinsurer expects to pay to the primary insurer vary with the cash flows from its share of the underlying items, so that the final cash flows paid to the policyholders vary similarly.

45 “Quota-share” (less than 100%) reinsurance contracts with direct participation features may have different features:

- A share in the premium paid by policyholders is transferred from the primary insurer to the reinsurer, who then invests in its own assets. An additional mechanism pools then together a substantial share in the returns on assets of the insurer and the reinsurer in order to return it to policyholders (see also illustrative example in § 48-50); or
- The premium paid by policyholders and the control on / management of the underlying assets are retained by the primary insurer. Such a scheme is designed to avoid the complexity of reflecting exactly the evolution of the underlying items held by the insurer: by nature, all the underlying items, both the reinsurer's and the primary insurer's parts, are similar. However, the reinsurer retains the full ownership and responsibility of its share in the underlying items: the primary insurer acts as an asset manager for the ceded share of the underlying items (see also illustrative example in § 52-53).

46 In the first case the insurer and the reinsurer manage their own share of assets, and then pool the returns, whereas in the second case, the reinsurer and the primary insurer benefit from the same pool of underlying items (managed by the primary insurer).

47 VFA criteria (as defined in IFRS 17.B101) depend upon what the policyholder is expecting to receive rather than what the insurer and the reinsurer are expecting to receive from the underlying items. Actually, in both cases:

- Policyholders participate in a share of a clearly identified pool of underlying items;
- The expected amount to be paid to policyholders is equal to a substantial share of the fair value returns on the underlying items.
- A substantial proportion of any change in the amounts to be paid to the policyholder is expected to vary with the change in fair value of the underlying items.

Illustrative example 1 – "Préfon"

48 For 50 years, Préfon has been put in place in order to provide a voluntary additional life and protection insurance scheme to French civil servants. Préfon nowadays manages around 13 b€.

49 Préfon is managed through a regulated association which has contracted a group insurance contract with a large insurance company in charge of the administration of the contracts. The policy is reinsured by three other insurers (assuming 35%, 20% and 10% of the risk). The insurer and the three reinsurers are responsible for the financial management and performance of the life insurance contracts and bound together with the association through an agreement.

50 From a prudential, contractual and economic point of view, the service provided by the three reinsurers is proportional reinsurance (and not co-insurance) because:

- Each reinsurer receives a share in the premiums and manages it in their respective assets. After deduction of a management fee, all the performance of the underlying items is returned to the primary insurer and then passed through to policyholders. The reinsurance management fee is calculated based on the reinsurer's liability against the primary insurer;
- Under certain conditions, a reinsurer may terminate the treaty and thus leave its share to the primary insurer (but not to the other reinsurers). This would not be possible in a co-insurance or co-reinsurance contract.

51 Regarding the application of the VFA criteria (IFRS 17.B 101) to this illustrative example:

- From the policyholders' point of view, the underlying items are clearly identified as the sum of the reinsurers-managed share and the primary-insurer managed share in the underlying items;
- A substantial proportion of the cash flows the reinsurers expect to pay to the primary insurer and then passed-through to policyholders vary with the changes in fair value of the underlying items;
- All returns on underlying items (less management fees paid to reinsurers and to the primary insurer) are returned to policyholders. As a result, a substantial proportion of any change in the amounts to be paid to the policyholder is expected to vary with the change in fair value of the underlying items.

Illustrative example 2 – "Quota-share treaty"

52 A quota-share (proportional) reinsurance treaty where the reinsurer accepts a fixed share in every risks covered by the primary insurer and where the primary insurer:

- does not necessarily pays upfront to the reinsurer an implicit part of the premium, but, in following periods:
  - pays to the reinsurer the same fixed share in the profits generated by the underlying insurance contracts; or
  - receives from the reinsurer the same fixed share in the losses generated by the underlying insurance contracts;
- in addition:
  - manages the administrative work on contracts, receiving as compensation a specific commission;
  - performs the financial management of the underlying assets over which it retains control. Conversely, the reinsurer does not have any control on assets and is therefore bound to the asset management performed by the insurer.

53 Regarding the application of the VFA criteria (IFRS 17.B 101) to this illustrative example:

- The underlying items are clearly identified and they are held by the primary insurer who has the primary responsibility towards the policyholder for managing them appropriately and a secondary responsibility towards the reinsurer for managing the ceded share of the underlying items in the same way as the retained share;
- The reinsurer expects to pay to the primary insurer an amount equal to a substantial share of the returns from the ceded share of the underlying items, as the contract between the reinsurer and the primary insurer specifies that these returns will be returned to policyholders;
- A substantial proportion of the cash flows the reinsurer expects to be finally paid to the primary insurer are expected to vary with cash flows from the ceded share of underlying items, because there is a replication of the contract between the primary insurer and the policyholder.

<u>Reinsurance contracts issued with direct participation features</u>

54 In contradiction with the view expressed in IFRS 17.BC 249, some reinsurance contracts issued actually provide an indirect compensation for the underlying insurance service rendered to policyholders. And for that service, the reinsurer does not only receive a fixed premium but rather a share of the returns in a pool of underlying items. Such reinsurance contracts, in addition to meeting the criteria for VFA contracts (see also § 53 and § 51) also comply with the view depicted in IFRS 17.BC 241.

<u>Reinsurance contracts held with direct participation features</u>

55 In contradiction with IFRS 17.BC 248, reinsurance contracts held may actually have direct participation features and meet the VFA criteria (the same way the related insurance contracts liabilities do).

56 However, because of IFRS 17.B109, accounting treatments of the VFA cannot apply: Any change in the financial risk (e.g. a change in the discount rate) of reinsurance contracts held is immediately recognised in the current result or OCI (general model). Under the VFA, the same change in the financial risk is reflected in the CSM of the underlying participating insurance contracts and therefore spread in the result over the coverage period. As a result, the combination of insurance and reinsurance contracts will therefore lead to an accounting mismatch in the statement of performance (and possibly OCI) for any change in the financial risk over the coverage period.

2.3 Accounting mismatch on reinsurance of an insurance contract being onerous at initial recognition

57 According to IFRS 17.BC 310, a net gain on purchasing reinsurance is expected to be rare because the reinsurance premium paid by a ceding entity will typically exceed the expected present value of cash flows generated by the reinsurance contracts held, plus the risk adjustment for non-financial risks.

58 However, several factors may lead to situations where reinsurance contracts may give rise to gains such as:

- Upfront reinsurance commissions to cover the initial acquisitions incurred in expectation of the future renewals;
- Additional mutualisation benefits arising from larger reinsurance portfolios, thus allowing to charge a lower reinsurance premium than the fulfilment cash outflows estimated by the ceding company;
- Additional diversification benefits available for the reinsurer, thus allowing to charge a lower reinsurance premium than the fulfilment cash outflows estimated by the ceding company.

59 On initial recognition, losses are recognised upfront for primary insurance contracts that are onerous at inception. By contrast, any net gain on related reinsurance contracts held is recognised over the life of the reinsurance contract held (except for covered events already occurred). This accounting treatment creates a mismatch and therefore does not reflect the mitigation expected from the reinsurance held.

60 If an insurance contract is not onerous at inception but becomes onerous later on, there is no such a mismatch. Indeed, IFRS 17.66(c)(ii) ensures that any change in the fulfilment cash flows impacting the CSM of an insurance contract is also reflected in the fulfilment cash flows impacting the CSM of the corresponding reinsurance contract held.

61 In other words, IFRS 17 provides for a symmetrical accounting treatment of the reinsurance contracts held and the underlying insurance contracts except at initial recognition. From an economical and conceptual point of view, there is no reason to distinguish those situations where absent a reinsurance contract, no such onerous contract would have been accepted/issued.

2.4 Contract boundaries of reinsurance contracts held differ from underlying liabilities boundaries

<u>Reinsurance contracts may include cash flows from contracts not yet written</u>

62 The reinsurance contract's boundary stems from the substantive right and obligation of the primary insurer which includes receiving service from the reinsurer in exchange for the reinsurance premium. Thus the substantive right to receive services from the reinsurer ends when the reinsurer has the practical ability to reassess the risks transferred and to set a price accordingly. As a consequence, the fulfilment cash flows arising from the reinsurance contracts may include cash flows from contracts not yet written.

63 Hence, the definition of the boundary applicable to reinsurance contracts does not require consistency with the underlying insurance contracts and is rather assessed based on the contractual features of the reinsurance contract itself. Taking into account the expected future insurance contracts reflects the way reinsurers manage their business rather than the way primary insurers do. From an economic point of view, reinsurance held (being proportional or non-proportional, life or non-life) aims at mitigating the insurance risks recorded in the underlying liabilities.

Resulting risk of mismatch

64 Inconsistencies between reinsurance contracts held and related insurance contracts may crystallise in the following accounting treatments:

- Applying different discount rates result in mismatches in the financial result;
- Differences in the measurement of CSM and differences in allocation periods (coverage units) lead to mismatches in the insurance result (notably linked with the difference between the assessment of future contracts and the assessment of future cash flows when such contracts are eventually recognised, or changes in estimates in key assumptions).

Is a distinction between proportional and non-proportional reinsurance relevant for recognition and measurement purposes?

65 Recognition provisions set in IFRS 17.62 make a distinction between proportional and non-proportional reinsurance contracts. We analyse below whether such distinction is also relevant when setting contracts boundaries:

- Proportional reinsurance: is similar to a swap that generally provides a coverage with no value until the underlying contract is recognised. The value of the coverage thus depends on the recognised contracts. Premium to the reinsurer is generally not paid upfront but as insurance contracts are issued.
- Non proportional reinsurance: is similar to an option that provides no coverage until losses exceed the threshold. The value of the coverage depends on the cumulative exposition to all expected insurance contracts. Premium to the reinsurer is generally paid upfront.

66 In practice reinsurance contracts generally do not exceed one year and cover the calendar year. Questions about contract boundaries therefore mainly relate to intermediary financial statements. In our view, applying IAS 34 interim financial reporting, consistent with other situation (income tax, yearly step-up rebates,…) leads to consider the year-to-date cost of insurance (including any mitigating effect of reinsurance) and to allocate it when appropriate (IAS 34.40) to the reporting period. Accordingly, an entity would not wait until losses exceed the threshold for recognising the benefits of a non-proportional reinsurance which is expected to strike at year-end.

Illustrative example 3 – "Non proportional reinsurance"

67 In a non-proportional reinsurance treaty a reinsurer accepts to cover losses exceeding cumulatively 70 in a year. The primary insurer expects losses cumulating

to 100 at year end. Losses are incurred on a steady basis so that cumulative losses incurred as of 30/6 amount to 50.

68 In its interim report as of 30/6, the entity should:

- View 1: present no gain from reinsurance since the threshold is not yet reached; or
- View 2: present a gain amounting to (100-70)/2=15 corresponding to the proportion of the year-end expected gain on the reinsurance?

69 We support view 2: the coverage should be accounted for in proportion of the underlying contracts recognised as expected. Accordingly the recognition criterion on non-proportional reinsurance benefits is similar to proportional reinsurance, even if the measurement appears more complex.

Conclusion

70 As a conclusion, the recognition of reinsurance contracts held and their related CSM is closely related to the recognition of the underlying contracts. There is no reason for differentiating proportional from non-proportional reinsurance held even if the measurement of the latter may prove more complex.

71 Recognising reinsurance contracts cash flows relating to insurance contracts not yet written leads to present the corresponding CSM in the balance sheet without allocating it to the P&L. This provides information of little relevance whereas it raises significant costs due to the operational complexity to deal with such temporary estimates in the IT systems and their possible discounting effect and subsequent changes in estimates (See § 64). Based on a cost/benefit analysis, we therefore suggest limiting the reinsurance contracts' boundaries to the recognised underlying contracts.

2.5 Presentation issues in the statement of financial performance of a reinsurer

72 IFRS 17 does not address the presentation of amounts exchanged between a reinsurer and the primary insurer. The TRG has suggested a presentation of common types of commissions due to the cedant and reinstatement premiums charged to the cedant following the occurrence of an insured event. TRG members have made suggestions based on whether such amounts are contingent on claims or not.

73 We find little basis in the standard (or even in the basis for conclusions) supporting these suggestions and therefore encourage IASB to add these provisions in the standard itself (as it was previously suggested in § 41(b) of ED/2013/7).

3 Suggested solution (tentative)

3.1 Suggested modifications relating to the prohibition of applying the VFA to reinsurance contracts held or issued

74 The prohibition of the VFA for reinsurance contracts (IFRS 17.B109) is justified in IFRS 17.BC 248 for reinsurance contracts held and in IFRS 17.BC 249 for reinsurance contracts issued. However, contracts may have features that contradict the key assumptions retained in the basis for conclusions for prohibiting applying the VFA either to held or issued reinsurance contracts. We therefore suggest removing the prohibition and apply to reinsurance contracts the same VFA criteria as insurance contracts.

Suggested modifications

75 IFRS 17.B 109: ~~Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of IFRS 17.~~

3.2 Suggested modifications relating to accounting mismatch on reinsurance of onerous insurance

76 The Australian TRG[1] has suggested two solutions:

- immediate recognition of the gain on reinsurance; or
- deferring losses on insurance contracts issued at the same time as gains on reinsurance held.

77 The second suggestion is a more complex one since (i) it requires more changes to the standard, i.e. also amending IFRS 17.82, and (ii) it is more complex to follow and may not be fully neutral in the presentation of the statement of performance.

78 ANC therefore supports the first solution that achieves a continuous symmetry in the accounting treatment of reinsurance contract held and the underlying insurance contracts issued. This solution suggests to extend “the subsequent measurement requirement set out in IFRS 17.66(c)(ii) […] to initial recognition so that, to the extent the reinsurance contract held on initial recognition covers onerous underlying contracts, the reinsurance benefit is recognised in the profit or loss instead of as a CSM on the balance sheet where they result from the losses on those underlying contracts”

Suggested modifications:

79 IFRS 17.62: Instead of applying paragraph 25, and except where paragraph 65 (c) applies, an entity shall recognise a group of reinsurance contracts held:

(a) if the reinsurance contracts held provide proportionate coverage—at the beginning of the coverage period of the group of reinsurance contracts held or at the initial recognition of any underlying contract, whichever is the later; and

(b) in all other cases—from the beginning of the coverage period of the group of reinsurance contracts held.

80 IFRS 17.65: The requirements of paragraph 38 that relate to determining the contractual service margin on initial recognition are modified to reflect the fact that for a group of reinsurance contracts held there is no unearned profit but instead a net cost or net gain on purchasing the reinsurance. Hence, on initial recognition:

(a) the entity shall recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of the fulfilment cash flows, the amount derecognised at that date of any asset or liability previously recognised for cash flows

[1] Australian TRG 2018-07-20 § 2.8(2)

related to the group of reinsurance contracts held, and any cash flows arising at that date; unless

(b) the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, in which case, notwithstanding the requirements of paragraph B5, the entity shall recognise such a cost immediately in profit or loss as an expense;~~.~~ or

(c) where the group of reinsurance contracts held covers underlying insurance contracts that are onerous, in which case the entity shall recognise a net gain on purchasing the group of reinsurance immediately in profit or loss to the extent the gain relates to losses on the group of underlying insurance contracts that are recognised in profit or loss.

3.3 Suggested modifications relating to reinsurance contracts boundaries

81 We refer to “Appendix 1: application of specific provisions on reinsurance contracts held (IFRS 17.60-.70)” presenting a simulation of the specific provisions relating to the accounting of reinsurance contracts held. It appears complex to amend these provisions that will eventually modify the general provisions in order to reflect a proper recognition and measurement of reinsurance contracts.

82 IFRS 17.63 refers to IFRS 17.34 in order to set the boundaries of insurance contracts held. This boundaries end with those of reinsurance contracts issued rather than with those of underlying liabilities. We suggest amending IFRS 17.63 in order to align the boundaries of insurance contracts held with those of recognised underlying contracts.

Suggested modifications

83 IFRS 17.63: ~~In applying t~~The measurement requirements of paragraphs 32–36 to reinsurance contracts held apply~~,~~ to the extent that the underlying contracts are recognised. ~~also measured applying those paragraphs , t~~ The entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

3.4 Suggested modifications relating to presentation issues in the statement of financial performance of a reinsurer

84 In order to avoid standard-setting out of the standards, we encourage IASB to introduce into IFRS 17 the suggestions made by TRG members on the presentation of exchange amounts between reinsurer and primary insurer, that currently lack a conceptual basis.

4 Appendix 1: application of specific provisions on reinsurance contracts held (IFRS 17.60-.70)

According to IFRS 17, reinsurance contracts have to be accounted for as separate contracts, i.e. not as an element of the cash-flows of the underlying insurance contracts. As a consequence, reinsurance contracts held are subject to the general standard's provisions with some adjustment expressed in IFRS 17.60-70.

Such adjustments have been reflected below (direct in red, indirect/contextual in blue)

Application of IFRS 17.61 on the level of aggregation

85 IFRS 17.14: An entity shall identify portfolios of **re**insurance contracts **held**. A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.

~~86 IFRS 17.15: Paragraphs 16–24 apply to insurance contracts issued. The requirements for the level of aggregation of reinsurance contracts held are set out in paragraph 61.~~

87 IFRS 17.16: An entity shall divide a portfolio of ~~insurance contracts issued~~ **reinsurance contracts held** into a minimum of:

(a) a group of contracts ~~that are onerous~~ **on which there is a net gain on initial recognition**, if any;

(b) a group of contracts that at initial recognition have no significant possibility of ~~becoming onerous~~ generating a net gain subsequently, if any; and

(c) a group of the remaining contracts in the portfolio, if any.

88 IFRS 17.17: If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if there are contracts ~~are~~ **on which there is a net gain on initial recognition** (see paragraph 47) and assess the set of contracts to determine if the contracts have no significant possibility of ~~becoming onerous~~ generating a net gain subsequently (see paragraph 19). If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.

89 IFRS 17.18: For ~~contracts issued~~ **reinsurance contracts held** to which an entity applies the premium allocation approach (see paragraphs 53–59), the entity shall assume there is no contracts in the portfolio ~~are~~ **on which there is a net gain on initial recognition**, unless facts and circumstances indicate otherwise. An entity shall assess whether contracts that ~~are not~~ **on which there is a net gain on initial recognition** at initial recognition have no significant possibility of ~~becoming onerous~~ generating a net

subsequently by assessing the likelihood of changes in applicable facts and circumstances.

90 IFRS 17.19: For ~~contracts issued~~ **reinsurance contracts held** to which an entity does not apply the premium allocation approach (see paragraphs 53–59), an entity shall assess whether contracts ~~that are not~~ **on which there is a net gain on initial recognition** have no significant possibility of ~~becoming onerous~~ generating a net gain:

(a) based on the likelihood of changes in assumptions which, if they occurred, would result in the contracts ~~becoming onerous~~ generating a net gain.

(b) using information about estimates provided by the entity's internal reporting. Hence, in assessing whether contracts ~~that are not~~ **on which there is ~~a~~** no **net gain on initial recognition** have no significant possibility of ~~becoming onerous~~ generating a net gain:

(i) an entity shall not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their ~~becoming onerous~~ generating a net gain; but

(ii) an entity is not required to gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts.

91 IFRS 17.20: If, applying paragraphs 14–19, contracts within a portfolio would fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group. The entity shall not apply this paragraph by analogy to other items.

92 IFRS 17.21: An entity is permitted to subdivide the groups described in paragraph 16. For example, an entity may choose to divide the portfolios into:

(a) more groups ~~that are not~~ **on which there is ~~a~~** no **net gain on initial recognition**—if the entity's internal reporting provides information that distinguishes:

(i) different levels of profitability; or

(ii) different possibilities of contracts ~~becoming onerous~~ generating a net gain after initial recognition; and

(b) more than one group of contracts ~~that are~~ **on which there is a net gain on initial recognition**—if the entity's internal reporting provides information at a more detailed level about the extent to which **there is a net gain on initial recognition** of the contracts ~~are **on which**~~.

93 IFRS 17.22: An entity shall not include ~~contracts issued~~ **reinsurance contracts held** more than one year apart in the same group. To achieve this, the entity shall, if necessary, further divide the groups described in paragraphs 16–21.

94 IFRS 17.23: A group of **re**insurance contracts **held** shall comprise a single contract if that is the result of applying paragraphs 14–22.

95 IFRS 17.24: An entity shall apply the recognition and measurement requirements of IFRS 17 to the groups of ~~contracts issued~~ **reinsurance contracts held** determined by applying paragraphs 14-23. An entity shall establish the groups at initial recognition, and shall not reassess the composition of the groups subsequently. To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group, applying paragraphs 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.

Application of IFRS 17.62 on recognition

96 IFRS 17.62: ~~Instead of applying paragraph 25,~~ An entity shall recognise a group of reinsurance contracts held:

(a) if the reinsurance contracts held provide proportionate coverage—at the beginning of the coverage period of the group of reinsurance contracts held or at the initial recognition of any underlying contract, whichever is the later; and

(b) in all other cases—from the beginning of the coverage period of the group of reinsurance contracts held.

Application of IFRS 17.63 on measurement

97 IFRS 17.32 On initial recognition, an entity shall measure a group of **re**insurance contracts **held** at the total of:

(a) the fulfilment cash flows, which comprise:

(i) estimates of future cash flows (paragraphs 33–35);

(ii) an adjustment to reflect the time value of money and the financial risks related to the future cash flows, to the extent that the financial risks are not included in the estimates of the future cash flows (paragraph 36); and

(iii) a risk adjustment for non-financial risk (paragraph 37).

(b) the contractual service margin, measured applying paragraphs 38–39.

Estimates of future cash flows (paragraphs B36–B71)

98 IFRS 17.33: An entity shall include in the measurement of a group of **re**insurance contracts **held** all the future cash flows within the boundary of each contract in the group (see paragraph 34). Applying paragraph 24, an entity may estimate the future cash flows at a higher level of aggregation and then allocate the resulting fulfilment cash flows to individual groups of contracts. The estimates of future cash flows shall:

(a) incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows (see paragraphs B37–B41). To do this, an entity shall estimate the expected value (ie the probability-weighted mean) of the full range of possible outcomes. **To the extent that the underlying contracts are also measured applying paragraphs**

32-36, the entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

(b) reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices for those variables (see paragraphs B42–B53).

(c) be current—the estimates shall reflect conditions existing at the measurement date, including assumptions at that date about the future (see paragraphs B54–B60).

(d) be explicit—the entity shall estimate the adjustment for non-financial risk separately from the other estimates (see paragraph B90). The entity also shall estimate the cash flows separately from the adjustment for the time value of money and financial risk, unless the most appropriate measurement technique combines these estimates (see paragraph B46).

99 IFRS 17.34: Cash flows are within the boundary of a~~n~~ **re**insurance contract **held** if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services (see paragraphs B61–B71). A substantive obligation to provide services ends when:

(a) the entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or

(b) both of the following criteria are satisfied:

(i) the entity has the practical ability to reassess the risks of the portfolio of **re**insurance contracts **held** that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and

(ii) the pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

100 IFRS 17.35: An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the **re**insurance contract **held**. Such amounts relate to future **re**insurance contracts **held**.

Discount rates (paragraphs B72–B85)

101 IFRS 17.36: An entity shall adjust the estimates of future cash flows to reflect the time value of money and the financial risks related to those cash flows, to the extent that the financial risks are not included in the estimates of cash flows. The discount rates applied to the estimates of the future cash flows described in paragraph 33 shall:

(a) reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the **re**insurance contracts **held**;

(b) be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the **re**insurance contracts **held**, in terms of, for example, timing, currency and liquidity; and

(c) exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the **re**insurance contracts **held**.

Application of IFRS 17.64 on risk adjustment

102 IFRS 17.64: ~~Instead of applying paragraph 37, a~~ **A**n entity shall determine the risk adjustment for non-financial risk so that it represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.

Application of IFRS 17.65 on CSM on initial recognition

~~103~~ IFRS 17.38: The contractual service margin is a component of the asset or liability for the group of **re**insurance contracts **held** that represents the ~~unearned profit~~ **net cost or net gain on purchasing the reinsurance** the entity will recognise as it provides services in the future. ~~An entity shall measure the contractual service margin on initial recognition of a group of insurance contracts at an amount that, unless paragraph 47 (on onerous contracts) applies, results in no income or expenses arising from:~~

~~(a) the initial recognition of an amount for the fulfilment cash flows, measured by applying paragraphs 32–37;~~

~~(b) the derecognition at the date of initial recognition of any asset or liability recognised for insurance acquisition cash flows applying paragraph 27; and~~

~~(c) any cash flows arising from the contracts in the group at that date~~.

Hence, on initial recognition:

(a) the entity shall recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of the fulfilment cash flows, the amount derecognised at that date of any asset or liability previously recognised for cash flows related to the group of reinsurance contracts held, and any cash flows arising at that date; unless

(b) the net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, in which case, notwithstanding the requirements of paragraph B5, the entity shall recognise such a cost immediately in profit or loss as an expense.

Application of IFRS 17.66 on CSM on subsequent measurement

Subsequent measurement

104 IFRS 17.40: The carrying amount of a group of **re**insurance contracts **held** at the end of each reporting period shall be the sum of:

(a) the liability for remaining coverage comprising:

(i) the fulfilment cash flows related to future service allocated to the group at that date, measured applying paragraphs 33–37 and B36–B92;

(ii) the contractual service margin of the group at that date, measured applying paragraphs 43–46; and

(b) the liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date, measured applying paragraphs 33–37 and B36–B92.

105 IFRS 17.41: An entity shall recognise income and expenses for the following changes in the carrying amount of the liability for remaining coverage:

(a) insurance revenue—for the reduction in the liability for remaining coverage because of services provided in the period, measured applying paragraphs B120–B124;

(b) insurance service expenses—~~for losses on groups of onerous contracts, and reversals of such losses (see paragraphs 47–52)~~; and

(c) insurance finance income or expenses—for the effect of the time value of money and the effect of financial risk as specified in paragraph 87.

106 IFRS 17.42: An entity shall recognise income and expenses for the following changes in the carrying amount of the liability for incurred claims:

(a) insurance service expenses—for the increase in the liability because of claims and expenses incurred in the period, excluding any investment components;

(b) insurance service expenses—for any subsequent changes in fulfilment cash flows relating to incurred claims and incurred expenses; and

(c) insurance finance income or expenses—for the effect of the time value of money and the effect of financial risk as specified in paragraph 87.

Contractual service margin (paragraphs B96—B119)

107 IFRS 17.43: The contractual service margin at the end of the reporting period represents the profit in the group of **re**insurance contracts **held** that has not yet been recognised in profit or loss because it relates to the future service to be provided under the contracts in the group.

~~108 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.~~

109 IFRS 17.66: ~~Instead of applying paragraph 44, a~~ **A**n 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.

110 IFRS 17.67: Changes in the fulfilment cash flows that result from changes in the risk of non-performance by the issuer of a reinsurance contract held do not relate to future service and shall not adjust the contractual service margin.

111 IFRS 17.68: Reinsurance contracts held cannot be onerous. Accordingly, the requirements of paragraphs 47–52 do not apply.

5 Appendix 2: Bases for conclusions

112 IFRS 17.BC 241: The Board decided that these differences are necessary to give a faithful representation of the different nature of the fee in these contracts. As explained in paragraphs BC228–BC231, the Board concluded that for many insurance contracts it is appropriate to depict the gains and losses on any investment portfolio related to the contracts in the same way as gains and losses on an investment portfolio unrelated to insurance contracts. However, the Board also considered a contrasting view that, for some contracts, the returns to the entity from a pool of underlying items should be viewed as the compensation that the entity charges the policyholder for service provided by the insurance contract, rather than as a share of returns from an unrelated investment. Under this contrasting view, changes in the estimate of the entity's share of returns are regarded as a change in the entity's compensation for the contract. Such changes in the entity's compensation should be recognised over the periods in which the entity provides the service promised in the contract, in the same way that changes in the estimates of the costs of providing the contract are recognised.

113 IFRS 17.BC 248: For reinsurance contracts an entity holds, the entity and the reinsurer do not share in the returns on underlying items, and so the criteria in paragraph BC238 are not met, even if the underlying insurance contracts issued are insurance contracts with direct participation features. The Board considered whether it should modify the scope of the variable fee approach to include reinsurance contracts held, if the underlying insurance contracts issued are insurance contracts with direct participation features. But such an approach would be inconsistent with the Board's view that a reinsurance contract held should be accounted for separately from the underlying contracts issued.

114 IFRS 17.BC 249: Although some types of reinsurance contracts issued might meet the criteria in paragraph BC238, the Board decided that reinsurance contracts issued are not eligible for the variable fee approach. This is because the view that the returns to the entity from a pool of underlying items should be viewed as part of the compensation that the entity charges the policyholder for the service provided by the insurance contract (see paragraph BC241) does not apply to reinsurance contracts issued.

Reinsurance contracts (paragraphs 60–70 of IFRS 17)

115 IFRS 17.BC 296: A reinsurance contract is a type of insurance contract. The Board identified no reason to apply different requirements to reinsurance contracts from those applied to other insurance contracts an entity issues. Consequently, IFRS 17 requires entities that issue reinsurance contracts to use the same recognition and measurement approach as they use for other insurance contracts.

116 IFRS 17.BC 297: Although both an issuer of direct insurance contracts and a reinsurer of those contracts will measure their contractual rights and obligations on the same basis, in practice they will not necessarily arrive at the same amount. Differences between the estimates for the reinsurance contract and the underlying contracts may arise because the issuer of the underlying insurance contracts and the reinsurer may base estimates on

access to different information; they may also make different adjustments for diversification effects.

117 IFRS 17.BC 298: IFRS 17 also applies to reinsurance contracts held by an entity (ie in which the entity is the policyholder). IFRS 17 requires a reinsurance contract held to be accounted for separately from the underlying insurance contracts to which it relates. This is because an entity that holds a reinsurance contract does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer. The Board acknowledged that separate accounting for the reinsurance contracts and their underlying insurance contracts might create mismatches that some regard as purely accounting, for example on the timing of recognition (see paragraphs BC304–BC305), the measurement of the reinsurance contracts (see paragraphs BC310–BC312) and the recognition of profit (see paragraph BC313). However, the Board concluded that accounting for a reinsurance contract held separately from the underlying insurance contracts gives a faithful representation of the entity’s rights and obligations and the related income and expenses from both contracts.

118 IFRS 17.BC 299: The amount an entity pays for reinsurance coverage consists of premiums the entity pays minus any amounts paid by the reinsurer to the entity to compensate the entity for expenses it incurs, such as underwriting or acquisition expenses (often referred to as ‘ceding commissions’). The amount paid for reinsurance coverage by the entity can be viewed as payment for the following:

(a) the reinsurer’s share of the expected present value of the cash flows generated by the underlying insurance contract(s). That amount includes an adjustment for the risk that the reinsurer may dispute coverage or fail to satisfy its obligations under the reinsurance contract held.

(b) a contractual service margin that makes the initial measurement of the reinsurance asset equal to the premium paid. This margin depends on the pricing of the reinsurance contract held and, consequently, may differ from the contractual service margin arising for the underlying insurance contract(s).

119 IFRS 17.BC 300: When estimating cash flows and the associated adjustments for the financial risk and the time value of money arising from reinsurance contracts held, the entity would use assumptions consistent with those it uses for the underlying contracts. As a result, the cash flows used to measure the reinsurance contracts held would reflect the extent to which those cash flows depend on the cash flows of the contracts they cover.

120 IFRS 17.BC 301: Consistent with the requirements for the measurement of insurance contracts an entity issues, the entity also may apply the premium allocation approach to simplify the measurement of reinsurance contracts held, provided that the resulting measurement is a reasonable approximation of the results that would be obtained by applying the general requirements of IFRS 17. The entity may also apply the premium allocation approach if the coverage period of each reinsurance contract held in the group is one year or less. Because groups of reinsurance contracts are

separate from the groups of underlying insurance contracts, the assessment of whether a group of reinsurance contracts meets conditions for applying the premium allocation approach may differ from the assessment of whether the group(s) of underlying insurance contracts meet(s) those conditions.

121 IFRS 17.BC 302: IFRS 17 modifies the requirements for reinsurance contracts held to reflect the fact that:

(a) groups of reinsurance contracts held are generally assets, rather than liabilities; and

(b) entities holding reinsurance contracts generally pay a margin to the reinsurer as an implicit part of the premium, rather than making profits from the reinsurance contracts.

122 IFRS 17.BC 303: The following paragraphs discuss aspects of the general principles in IFRS 17 in relation to groups of reinsurance contracts held:

(a) recognition for groups of reinsurance contracts held (see paragraphs BC304–BC305);

(b) derecognition (see paragraph BC306);

(c) cash flows (see paragraphs BC307–BC309); and

(d) contractual service margin (see paragraphs BC310–BC315).

Recognition for groups of reinsurance contracts held (paragraph 62 of IFRS 17)

123 IFRS 17.BC 304: Many reinsurance arrangements are designed to cover the claims incurred under underlying insurance contracts written during a specified period. In some cases, the reinsurance contract held covers the losses of separate contracts on a proportionate basis. In other cases, the reinsurance contract held covers aggregate losses from a group of underlying contracts that exceed a specified amount.

124 IFRS 17.BC 305: The Board decided to simplify the application of the principle that a contract should be recognised from the date the entity is exposed to risk for reinsurance contracts as follows:

(a) when the group of reinsurance contracts held covers the loss of a group of insurance contracts on a proportionate basis, the group of reinsurance contracts held is recognised at the later of the beginning of the coverage period of the group of reinsurance contracts held or the initial recognition of any underlying contracts. This means that the entity will not recognise the group of reinsurance contracts until it has recognised at least one of the underlying contracts.

(b) when the group of reinsurance contracts held covers aggregate losses arising from a group of insurance contracts over a specified amount, the group of reinsurance contracts held is recognised when the coverage period of the group of reinsurance contracts begins. In these contracts the entity benefits from coverage—in case the underlying losses exceed the threshold—from the beginning of the group of reinsurance contracts held because such losses accumulate throughout the coverage period.

Derecognition of underlying contracts (paragraphs 74–75 of IFRS 17)

125 IFRS 17.BC 306: An entity does not derecognise an insurance contract until the contractual obligations are extinguished by discharge, cancellation

or expiry (or on specified modifications of the contract). A reinsurance contract held typically protects the entity from the effects of some defined losses on the underlying group of insurance contracts, but does not eliminate the entity's responsibility for fulfilling its obligations under those contracts. It follows that the entity typically would not derecognise the related underlying insurance contracts upon entering into a reinsurance contract.

Cash flows in reinsurance contracts held (paragraph 63 of IFRS 17)

126 IFRS 17.BC 307: As required by paragraph 63 of IFRS 17, cash flows for a group of reinsurance contracts held should be estimated using assumptions that are consistent with those used for the group(s) of underlying insurance contracts. In addition, IFRS 17 requires entities to reflect expected credit losses in the measurement of the fulfilment cash flows. This is discussed in paragraphs BC308–BC309.

127 IFRS 17.BC 308: An entity holding reinsurance contracts faces the risk that the reinsurer may default, or may dispute whether a valid claim exists for an insured event. IFRS 17 requires the estimates of expected credit losses to be based on expected values. Hence, estimates of the amounts and timing of cash flows are probability-weighted outcomes after calculating the effect of credit losses.

128 IFRS 17.BC 309: IFRS 17 prohibits changes in expected credit losses adjusting the contractual service margin. In the Board's view, differences in expected credit losses do not relate to future service. Accordingly, any changes in expected credit losses are economic events that the Board decided should be reflected as gains and losses in profit or loss when they occur. This would result in consistent accounting for expected credit losses between reinsurance contracts held and purchased, and originated credit-impaired financial assets accounted for in accordance with IFRS 9.

Gains and losses on buying reinsurance (paragraph 65 of IFRS 17)

129 IFRS 17.BC 310: The amount paid by the entity to buy reinsurance contracts would typically exceed the expected present value of cash flows generated by the reinsurance contracts held, plus the risk adjustment for non-financial risk. Thus, a debit contractual service margin, which represents the net expense of purchasing reinsurance, would typically be recognised on the initial recognition of a group of reinsurance contracts held. The Board considered whether the contractual service margin of the group of reinsurance contracts held could be a credit if, as happens in rare cases, the amount paid by the entity is less than the expected present value of cash flows plus the risk adjustment for non-financial risk. Such a credit contractual service margin would represent a net gain on purchasing reinsurance. The most likely causes of such a net gain would be either of the following:

(a) an overstatement of the underlying insurance contract(s). An entity would evaluate this by reviewing the measurement of the underlying insurance contract(s).

(b) favourable pricing by the reinsurer; for example, as a result of diversification benefits that are not available to the entity.

130 IFRS 17.BC 311: The Board originally proposed that entities should recognise a gain when such a negative difference arose. The Board proposed this for symmetry with the model for the underlying group of insurance contracts and for consistency with the Board's conclusion that the contractual service margin for the underlying group of insurance contracts should not be negative. However, IFRS 17 requires entities to instead recognise the negative difference over the coverage period of the group of reinsurance contracts held. The Board was persuaded by the view that the apparent gain at initial recognition represents a reduction in the cost of purchasing reinsurance, and that it would be appropriate for an entity to recognise that reduction in cost over the coverage period as services are received.

131 IFRS 17.BC 312: The Board also decided that the net expense of purchasing reinsurance should be recognised over the coverage period as services are received unless the reinsurance covers events that have already occurred. For such reinsurance contracts held, the Board concluded that entities should recognise the whole of the net expense at initial recognition, to be consistent with the treatment of the net expense of purchasing reinsurance before an insured event has occurred. The Board acknowledged that this approach does not treat the coverage period of the reinsurance contract consistently with the view that for some insurance contracts the insured event is the discovery of a loss during the term of the contract, if that loss arises from an event that had occurred before the inception of the contract. However, the Board concluded that consistency of the treatment of the net expense across all reinsurance contracts held would result in more relevant information.

132 IFRS 17.BC 313: The Board considered the view that the amount of the contractual service margin included in the measurement of the group of reinsurance contracts held should be proportional to the contractual service margin on the group of underlying contracts instead of being measured separately by reference to the reinsurance premium. Under this approach, any difference between the amount recognised for the group of underlying insurance contracts and the reinsurance premium would be recognised in profit or loss when the group of reinsurance contracts held is initially recognised. This approach would depict a gain or loss equal to the shortfall or excess of the reinsurance premium the entity pays to the reinsurer above or below the premium that the entity receives from the policyholder. Thereafter, unearned profit from the group of underlying contracts would be offset by an equal and opposite expense for the reinsurance premium. However, in the Board's view, measuring the group of reinsurance contracts held on the basis of the premium the entity receives for the underlying contracts when that premium does not directly affect the cash flows arising from the group of reinsurance contracts held would be contrary to viewing the group of reinsurance contracts held and the underlying contracts as separate contracts. Such a measurement approach would also not reflect the economics of the group of reinsurance contracts the entity holds—that the expense of purchasing the group of reinsurance contracts (that should be recognised over the

coverage period) equals the whole of the consideration paid for the group of reinsurance contracts.

133 IFRS 17.BC 314: For the measurement of the group of insurance contracts the entity issues, IFRS 17 specifies that the contractual service margin can never be negative. IFRS 17 does not include a limit on the amount by which the contractual service margin of a group of reinsurance contracts held could be adjusted as a result of changes in estimates of cash flows. In the Board's view, the contractual service margin for a group of reinsurance contracts held is different from that for a group of insurance contracts issued—the contractual service margin for the group of reinsurance contracts held depicts the expense the entity incurs when purchasing reinsurance coverage rather than the profit it will make by providing services under the insurance contract. Accordingly, the Board placed no limit on the amount of the adjustment to the contractual service margin for the group of reinsurance contracts held, subject to the amount of premium paid to the reinsurer.

134 IFRS 17.BC 315: The Board considered the situation that arises when the underlying group of insurance contracts becomes onerous after initial recognition because of adverse changes in estimates of fulfilment cash flows relating to future service. In such a situation, the entity recognises a loss on the group of underlying insurance contracts. The Board concluded that corresponding changes in cash inflows from a group of reinsurance contracts held should not adjust the contractual service margin of the group of reinsurance contracts held, with the result that the entity recognises no net effect of the loss and gain in the profit or loss for the period. This means that, to the extent that the change in the fulfilment cash flows of the group of underlying contracts is matched with a change in fulfilment cash flows on the group of reinsurance contracts held, there is no net effect on profit or loss.

IFRS 17 issues – CSM allocation related to investment services

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.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.

7 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.

8 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).

9 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.

10 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 Suggested amendment (IASB June 2018)

11 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.

12 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.

13 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).

14 Suggested amendments would be as follows:

15 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.

16 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~~.

1.3 TRG

TRG Staff analysis (2018-05 AP 5)

17 §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.

18 §41: In contrast to the VFA, the staff observe the general model in IFRS 17 does not treat contracts as providing investment-related services. […]

19 §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.

TRG Conclusion (2018-05 Summary §39)

20 Most TRG members disagreed that insurance contracts under the general model should be treated as providing only insurance services.

1.4 Current understanding of the accounting treatment

21 The standard does not provide a definition of "coverage" or "investment related service".

22 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

23 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.

24 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).

25 IASB staff has expressed the view that insurance contracts with participation features generally (but not always) provide investment-related services in addition to insurance coverage. (IASB 2015-06.AP 2C § 11-12).

26 In June 2018 IASB staff has suggested a narrow amendment to modify the definition of the coverage period for VFA contracts (i.e. for insurance contracts with

participation features) to clarify that it includes the period in which investment-related services are provided, but this amendment explicitly excludes insurance contracts without direct participation features from such an accounting treatment.

27 At its January 2019 meeting the IASB will consider whether amending IFRS 17 or not, in particular:

- so that in the general model the contractual service margin should be allocated on the basis of coverage units that are determined by considering both insurance coverage and any investment return service;
- to establish that an investment return service exists only when an insurance contract includes an investment component;
- to require an entity to use judgement applied consistently in deciding whether to include an investment return service when determining coverage units and not provide an objective or criteria for that determination;
- 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, i.e. not including payments to future policyholders;
- to require the assessment of the relative weighting of the benefits provided by the insurance coverage and investment return service and their pattern of delivery to be made on a systematic and rational basis.

2 Issue

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

28 Investment-related 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-related services, not all do.

29 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.

30 Examples of non-VFA contracts providing investment-related 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).

2.2 The coverage period should explicitly include the period of investment related services.

31 Such a period generally ends with the last payment allocated to the current policyholders (i.e. not considering IFRS 17.B71 transfers to future policyholders).

2.3 The definition of coverage units should authorise/ encourage an adequate depiction of services rendered

32 In order to reflect profitability patterns and to allocate the CSM over the extended coverage period in an adequate way, it seems appropriate to adopt a principles-based approach allowing/encouraging to go beyond the mere passage of time by:

- authorising a distinction between the coverage for insured events CSM part and the investment-related services CSM part for a defined group of contracts,
- authorising adopting coverage units corresponding to the service rendered (for instance funds invested).

3 Suggested solution (tentative)

3.1 Discussion

33 We suggest extending the definition of the coverage period in order to take into consideration investment-related services. Assuming such an extension, since B119 applies to all contracts, this should be sufficient, subject to a minor clarification, to extend the possibility to consider investment-related services for any contract and not only to VFA contracts.

34 Since "investment-related 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

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

36 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-related 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~~.