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## **IFRS 17 – Towards a consultation paper on Release of the CSM Issues Paper**

### **Objective**

- 1 The objective of this paper is to provide a first draft of a consultation paper on the release of the contractual service margin (CSM) requirements of IFRS 17 *Insurance Contracts*. The document will also be discussed at the IAWG meeting on 25 January 2018.

### **Questions for EFRAG TEG**

- 2 Does EFRAG TEG have comments on this consultation paper?

## **Release of the contractual service margin**

Profit recognition under IFRS 17 *Insurance Contracts*

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## Introduction

1. This consultative document deals with the allocation<sup>1</sup> of the contractual service margin (CSM) to profit or loss as required by IFRS 17 *Insurance contracts*. As the CSM represents the unearned profit on a group of insurance contracts, its release to profit or loss over time will be significant in explaining the performance of insurance companies.
2. This is the second paper of three such consultative documents on IFRS 17. The aim of these documents is to obtain constituents' views on a timely basis on a range of important topics that EFRAG is considering as part of its endorsement advice.
3. The first paper in this series, *Level of Aggregation*, deals with the definition of a "group of insurance contracts" including the annual cohort requirement.
4. This consultative document relates to CSM and its allocation or release to profit or loss considers how will it work both the general model and for insurance contracts with direct participation features<sup>2</sup> under the so-called variable fee approach (VFA) as well as the impact of experience adjustments and the annual cohort requirement on the CSM release pattern. It does not deal with the premium allocation approach as that approach does not use the concept of the CSM.
5. Whilst IFRS 17 applies to all entities that write insurance contracts and not only insurance companies, it is expected that the biggest impact is on insurance companies which is why the focus of this paper and all references are to insurance companies or insurers.
6. Please respond with your comments, either on the detailed questions in this document or in general, by 30 April 2018.

## Why is this important?

7. Prior to the introduction of IFRS 17, insurers have reported their financial performance and position in a variety of ways. As part of its standardisation of insurance accounting, IFRS 17 introduces the concept of the CSM which will lead to significant changes in the reporting of performance for all insurers that will apply the new standard.
8. The CSM represents the profit still to be earned under the insurance contracts it has issued and the release of this unearned profit to profit or loss is expected to be the most significant component of both "insurance revenue" and the "insurance service result" under IFRS 17. It will therefore be important for preparers to explain and for users to understand the changes in CSM and how this impacts performance. Therefore this paper aims to explore the potential consequences of CSM and its release to profit or loss to assess this in the context of the endorsement criteria in the IAS Regulation (Regulation (EC) No 1606/2002 on the application of international accounting standards).

## What do insurance companies do at the moment?

9. Insurance companies currently apply IFRS 4 *Insurance Contracts* which is an interim standard that allows entities to use a wide variety of accounting practices for insurance contracts, reflecting local generally accepted accounting principles (GAAPs). IFRS 4 allows insurance companies to have different accounting policies for the same type of contract, e.g. an Estonian insurer with an insurance subsidiary in Portugal may apply both Estonian and Portuguese GAAP in its consolidated financial statements for the same type of insurance contract without adjustments.

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<sup>1</sup> Also referred to as release to profit or loss as well as CSM run-off.

<sup>2</sup> These are contracts where the policyholders share in the performance of underlying items and the insurer earns a variable fee based on the performance of these items. Examples include unit-linked contracts, continental European 90/10 contracts; and UK with-profits contracts. These are also called participating contracts. Please refer to Appendix 2 for the IFRS 17 definition.

10. Currently under the local GAAPs used under IFRS 4, there is no concept of a CSM or its release and generally profit recognition occurs through margins or additional buffers added to the valuation of the insurance liability. Profit is recognised through changes in these margins or buffers. However, in some cases, profit recognition may take place upfront (after estimating the amount to be ultimately paid out), in others, the margins or buffers will be adjusted so that profit will only be recognised at the end of the contract, and in a third possibility, the profit is recognised over time.

## What does IFRS 17 require?

### Initial recognition

11. IFRS 17 requires that no income or expense is recognised when recognising a group of insurance contracts. This means that the CSM of a group of insurance contracts at inception is equal but opposite to the sum of the following:

- fulfilment cash flows<sup>3</sup>;
- the related insurance acquisition asset or liability<sup>4</sup>; and
- any contractual cash flows<sup>5</sup> on that date.

The CSM represents the unearned profit under the group of contracts that relates to future service to be provided under the contracts. (IFRS 17 paragraph 38).

12. Where the CSM of a group represents an unearned loss on inception, this is immediately recognised in profit or loss as a group of onerous contracts. (IFRS 17 paragraph 47). (Please refer to the EFRAG paper *Level of aggregation* for a discussion on onerous contracts.)

### Subsequent measurement

13. After initial recognition, at each reporting date, the CSM is updated under the general model and the VFA for direct participating insurance contracts, as follows:

	General Model	VFA
New contracts added to the group (i.e. within the one year limit)	✓	✓
Changes in fulfilment cash flows that relate to future service	✓	✓
Interest accreted on the CSM during the period	✓	
Changes in the expected share of the fair value changes of underlying items		✓
Currency exchange differences	✓	✓
Release to profit or loss	✓	✓

14. The CSM cannot be negative, so where changes in the fulfilment cash flows that relate to future service exceed the carrying amount of the CSM and would result in a negative CSM, a loss for that amount is recognised in profit or loss. Where subsequent changes reverse such a loss, this is also recognised in profit or loss. (IFRS 17 paragraphs 48 and 50).

<sup>3</sup> These are the discounted probability weighted expected cash flows (both in- and out-flows such as premiums and claims but exclude expected return on investments – this is covered under IFRS 9 *Financial Instruments*) and the risk adjustment for non-financial risk.

<sup>4</sup> Currently often called the DAC or Deferred Acquisition Costs and refers to “cost of selling, underwriting and starting a group of insurance contracts” (IFRS 17 Appendix A). This includes commission paid.

<sup>5</sup> An example would be a premium received on inception.

### *Changes in fulfilment cash flows*

15. Changes in fulfilment cash flows that relate to future service (therefore adjusting the CSM) include the following:

- Experience adjustments<sup>6</sup> generally relate to past or current services and so do not adjust the CSM. However, experience adjustments arising from premiums received in the period that relate to future service adjust the CSM.  
(IFRS 17 paragraphs B96(a) and B97(b))
- Differences in the amount of investment components<sup>7</sup> expected to be paid and actually paid, adjust the CSM. The amount of an investment component is only determined when a claim incurred.  
(IFRS 17 paragraph B96(c))
- Changes to the risk adjustment for non-financial risk that relate to future service.  
(IFRS 17 paragraph B96(d))
- Changes in fulfilment cash flows in the liability for incurred claims do not adjust the CSM as these relate to current or past services.  
(IFRS 17 paragraph B97(b))

16. Changes to the expected discretionary cash flows<sup>8</sup> for contracts under the general model also adjust the CSM as it relates to future service. (IFRS 17 paragraphs B98-B100).

### *Interest accretion*

17. For contracts under the general model, interest on the CSM is accreted using the discount rate at inception of the contract. This discount rate does not vary based on returns on underlying items. IFRS 17 paragraph BC274 justifies the use of the locked-in rate as the CSM represents unearned profit in the contract rather than future cash flows. (IFRS 17 paragraph 44(b)).
18. Under the VFA, there is no explicit accretion of interest required however changes in the time value of money and financial risks not arising from the underlying items (e.g. financial guarantees) adjust the CSM and this represents an implicit adjustment of the CSM using current rates. (IFRS 17 paragraph 45).

### *The insurer's share of changes in fair value of the underlying items*

19. Changes in the insurer's obligation to policyholders equal to the fair value of the underlying items are recognised in profit or loss or other comprehensive income (OCI). However, changes relating to the insurer's share of the increase (i.e. the variable fee it earns under these contracts) adjust the CSM as it relates to future service except where a loss for onerous contracts or its reversal have been recognised. (IFRS 17 paragraph 45(b)) (See paragraph 14 above). CSM is also not adjusted if the insurer qualifies for and applies the risk mitigation option<sup>9</sup>. (IFRS 17 paragraphs 45 (c)(i); B115-B118)

### *Release to profit or loss*

20. The amount of CSM to be recognised in profit or loss for the period is determined by:

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<sup>6</sup> Experience adjustments arise from differences in estimates and the actual amounts. See Appendix 2 for the IFRS 17 definition

<sup>7</sup> These are those amounts that the insurer has to repay to a policyholder even if an insured event does not occur. (IFRS 17 Appendix A)

<sup>8</sup> Some contracts may not meet the definition of contracts with direct participating features but the insurer has discretion over the amount, timing or nature of cash flows of amounts to be paid to policyholders. These contracts are sometimes called indirect participating contracts.

<sup>9</sup> This is an option under IFRS 17 to reduce possible accounting mismatches where the insurer holds derivatives to manage the risk arising from contracts under the VFA.

- identifying the coverage units in the group;
- allocating the CSM equally to the coverage units for current and future periods; and
- recognising in profit or loss the amount allocated to coverage units for the period. (IFRS 17 paragraph B119)

The number of coverage units in a group is based on the quantity of benefits under each contract and the expected coverage duration.

**Example: Coverage units and release to profit or loss**

Assume five contracts in a new group, each with a duration of less than five years but longer than one year. The total CSM for the group has been determined to be €15. The quantity of benefits and duration per contract is as follows:

	Quantity of benefits	Duration (in years)
1	€20	5
2	€ 5	3
3	€ 5	4
4	€20	2
5	€10	5

Total quantity of benefits: 225 (sum of each contract's quantity of benefits multiplied by duration)

Weighting of quantity of benefits could be as follows:

	Quantity of benefits				
	Year 1	Year 2	Year 3	Year 4	Year 5
1	20	20	20	20	20
2	5	5	5		
3	5	5	5	5	
4	20	20			
5	10	10	10	10	10
<b>Total</b>	<b>60</b>	<b>60</b>	<b>40</b>	<b>35</b>	<b>30</b>

CSM allocation<sup>10</sup> per year and in total:

Year 1	Year 2	Year 3	Year 4	Year 5	Total
€ 4.00	€ 4.00	€ 2.67	€ 2.33	€ 2.00	<b>€15.00</b>

- The number of coverage units in a group is based on the quantity of benefits under each contract and the expected coverage duration. The quantity of benefits is not defined in the standard and therefore judgement will need to be exercised. Paragraph BC279 says "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."
- Further, the Basis for Conclusions of IFRS 17 states that the CSM allocation should not be based on the pattern of expected cash flows or the release of the risk adjustment as these are not relevant in determining the satisfaction of the performance obligation of the insurer. (IFRS 17 paragraph BC279 (a)). This indicates that the quantity of benefits refers to the insurer standing ready and not just the expected timing or amount of pay-out. Therefore, it is clear that the CSM is recognised over the whole coverage period and not just during those periods of heightened risk (such as during hurricane season for contracts covering hurricane damage).
- In many cases, the sum assured could be an appropriate measure such as in the case of a life insurance policy. However, certain products which do not include fixed amounts such as credit insurance where the amount to be paid out decreases as the underlying loan is

<sup>10</sup> This ignores accretion of interest as well as any other adjustments to CSM.

paid off means that the amount and the timing of the pay-out may vary. These scenarios add to the complexity and judgement to be exercised when determining the appropriate run-off. It may be useful to consider that coverage units aim to approximate the relative profitability of contracts in a group in order to measure and allocate the CSM appropriately based on its unit of account, the group of insurance contracts.

## Derecognition

24. The CSM includes expected derecognition events because coverage units include expected terminations such as lapses, surrenders or other terminating events such as death for life insurance, through the expected duration of the contracts in a group.
25. Where more contracts end than expected, either because of higher lapses or other terminating events, IFRS 17 requires that the fulfilment cash flows, the CSM of the group as well as the coverage units for future periods are adjusted<sup>11</sup> which would therefore impact the CSM run-off over time. As CSM is not allocated to a individual contracts, any adjustment to the CSM of the group would be an average amount based on the relevant coverage units being derecognised. (IFRS 17 paragraph 76 (b) and (c)).
26. Therefore, the coverage units per contract would be expected to be individually tracked increasing complexity and cost, but this is off-set by the fact that the underlying information is required for other operating purposes such as billing and claims.

## How does CSM run-off work under IFRS 17?

### Run-off patterns of CSM of a single group

#### General model

27. It is important to understand the typical run-off patterns of CSM under various circumstances. It is simplest to do this for a single group and to start with a simplified set of circumstances.
28. Under the general model, consider a group of contracts with expected terminations (such as lapses or death) in years 2 and 6 and all other circumstances happen as expected. In this case, the CSM release<sup>12</sup> to profit or loss would be linear except for the terminating events.

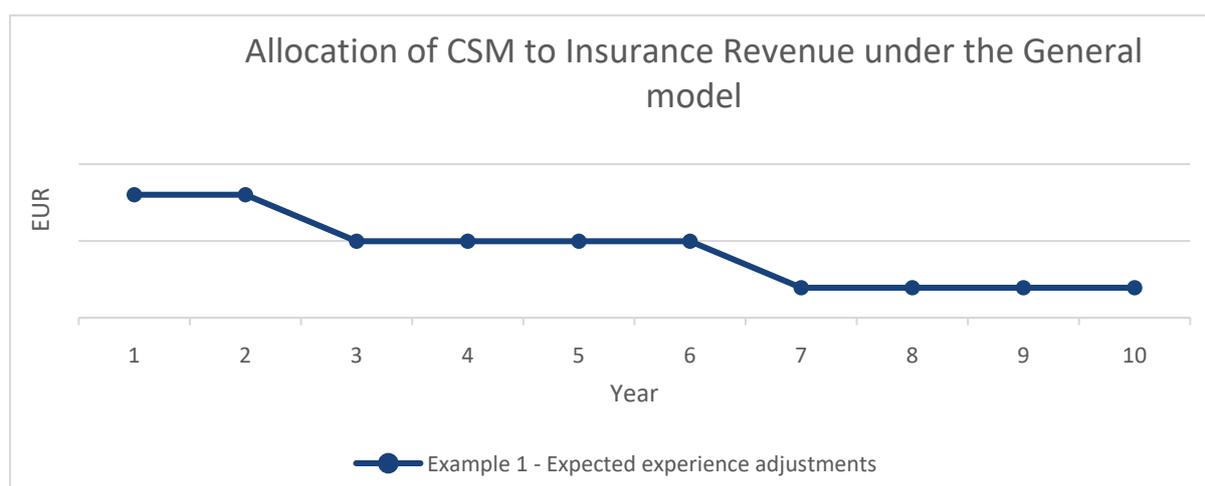


Fig. 1 – Allocation of CSM under the General model: expected terminations

<sup>11</sup> Therefore, the coverage units per contract would need to be tracked, but as CSM is not allocated to a contract level, the adjustment to CSM would be made on an average based on coverage units rather than the actual CSM related to each specific contract.

<sup>12</sup> For the sake of simplicity these examples about the run-off also exclude the accretion of interest or changes in discount rates.

29. The actual (and expected) terminating event in year 2 decreases both the coverage units as well as the CSM resulting in a decrease of the CSM release or allocation to profit and loss after that.
30. However, it is likely that there will be unexpected terminating events during the coverage period and as a result the insurer's expectations in respect of future premiums have changed (Figure 2 below). In that case, the CSM release after the terminating event would be lower compared to Example 1 above because:
- The number of coverage units would decrease after the terminating events; and
  - The change in the future cash flows impacts the CSM in this example.
31. The increase in CSM release in years 2 and 6 represents the remaining CSM of the additional contracts that were terminated during the year. The CSM calculation at inception anticipated a longer coverage period and the related CSM is now recognised earlier than anticipated.

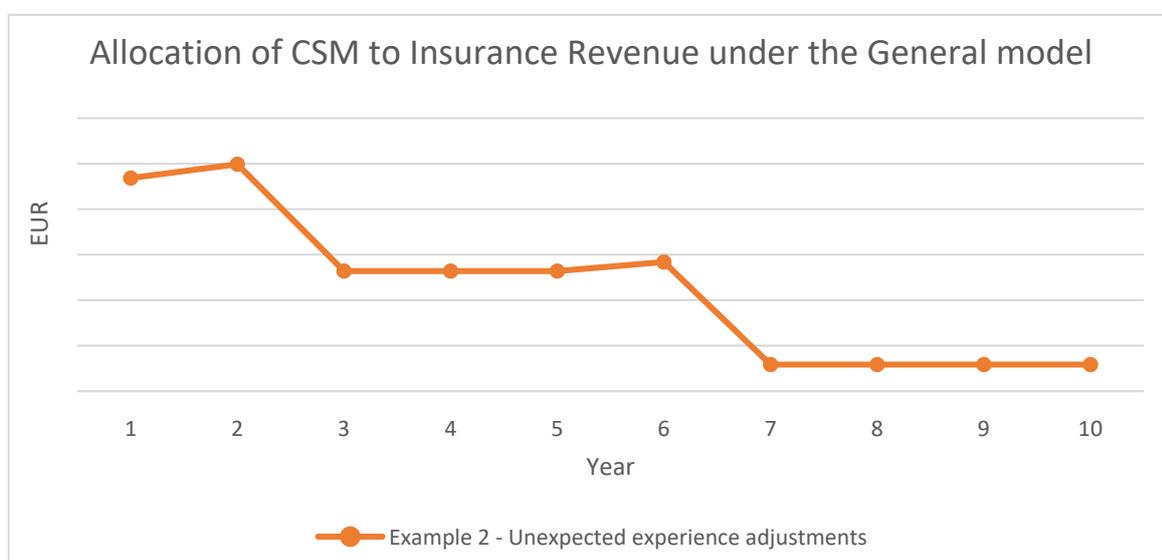


Fig. 2 – Allocation of CSM under the General model: unexpected terminations

#### Variable fee approach

32. Development in progress.

#### Impact of annual cohort requirement

33. In general, IFRS Standards specify accounting for each individual contract as that provides the most transparent information. Some IFRS Standards, as a practical expedient, permit an entity to apply the requirements of those Standards to a portfolio of contracts with similar characteristics. IFRS 17 similarly allows fulfilment cash flows ( see page XX) to be estimated on a higher level of aggregation than either group or portfolio. The CSM is measured and allocated to profit or loss on a group basis. (IFRS 17, paragraph 24)
34. Given that insurance entities utilise pooling of risks as part of their business model, not having to measure individual contracts provides relevant information about insurance activities.
35. The annual cohort requirement<sup>13</sup> creates a closed group for calculating the CSM allocation. In the absence of this requirement, the averaging of the impacts on the CSM could be

<sup>13</sup> IFRS 17 requires that groups of insurance contracts (the basis of calculating the CSM release) all have to have been issued within one year (IFRS 17 paragraph 22). For further details on this please refer to the EFRAG *Level of Aggregation* paper.

seen to continue indefinitely as new contracts would continue to be added to the group. Such averaging *over time* of the impacts of CSM could be avoided by tracking individual contracts, however this would reverse the benefit of grouping established by IFRS 17.

36. The annual cohort requirement aims to:

- (a) Identify onerous contracts on a timely basis;
- (b) Maintain the closed portfolio concept in IFRS 17 and prevent continuous averaging of CSM information over time;
- (c) Allocate CSM appropriately to profit or loss on a group basis resulting in meaningful profit trends as well as ensuring systematic allocation of CSM over the coverage period; and
- (d) Create consistency within the industry and compared to other industries on profit recognition.

37. This can be best illustrated by a simplified example:

Entity A issues the following cohorts of insurance contracts, with each cohort consisting of 20 contracts with a duration of 10 years:

	Issue date*	Total CSM
<b>Cohort A</b>	Year 1	€ 2,000
<b>Cohort B</b>	Year 5	€ 1,000
<b>Cohort C</b>	Year 7	€ 300

\*At beginning of the year

38. The graph below illustrates the pattern of contracts in force over time:



Fig. 3 – Number of contracts in force over time

39. This graph shows the CSM release to profit or loss when using annual cohorts (Example 3):

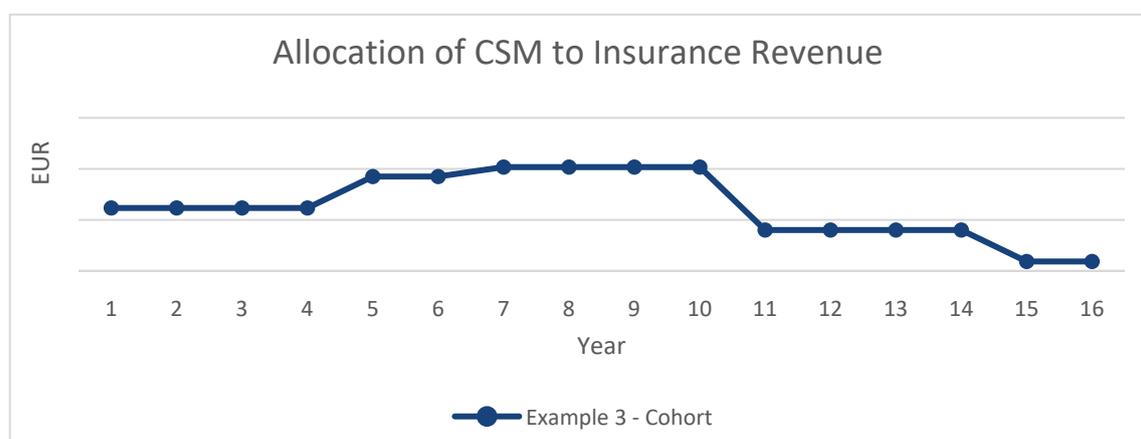


Fig 4 – Allocation of CSM: applying cohorts under IFRS 17

40. The CSM trend in the graph above reflects how cohorts are being established and run-off over time. With no cohorts but while tracking the maturity profile of the cohorts, the CSM release would have a different pattern (Example 4). The graph below compares Examples 3 and 4:

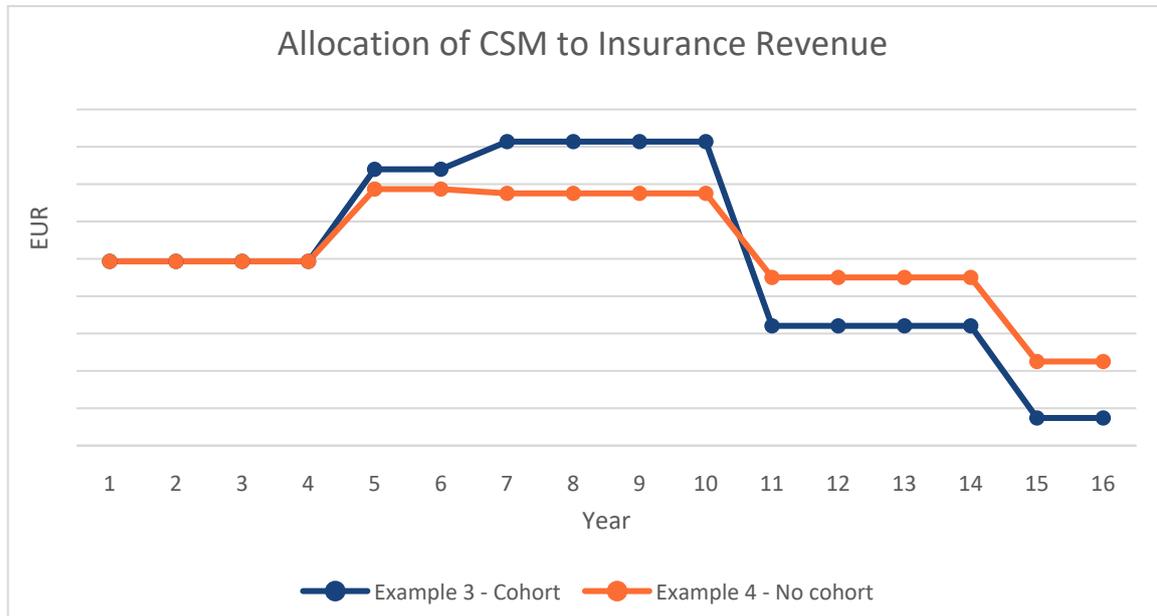


Fig 5 – Allocation of CSM: cohorts versus no cohorts – tracking maturity but not profitability

41. Example 4 shows the treatment of the CSM as an open portfolio and reflects the re-averaging of the CSM release over time as coverage units are changed. Therefore, in years 5 to 10, the CSM release is lower in Example 4 than Example 3 as the open portfolio spreads the remaining CSM from Cohort 1 beyond its maturity date of year 10. In later years, there is a blending of the different profitability levels of the differing cohorts.
42. In Example 4 above, it is assumed that maturity of the coverage units is tracked even if annual cohorts are not used, but if the maturity is not tracked the resulting release of CSM would change again. After the addition of the third cohort in Example 4 the CSM release would be a straight-line for the remaining coverage period as the maturity of the first two cohorts are ignored (ignoring the impact of accretion of interest). This method extends the CSM release beyond the maturity of the first two cohorts and results in a CSM release that tracks the long-term average over time.

#### Interest accretion

43. For contracts under the general model, the CSM is accreted using discount rates at the start of the contract (i.e., the discount rate is locked-in). If the CSM for contracts under the general model were to be updated for changes in rates, using a simplified example with an increase in discount rate as from the end of year 4, the impact on the closing balance of CSM could be as follows:

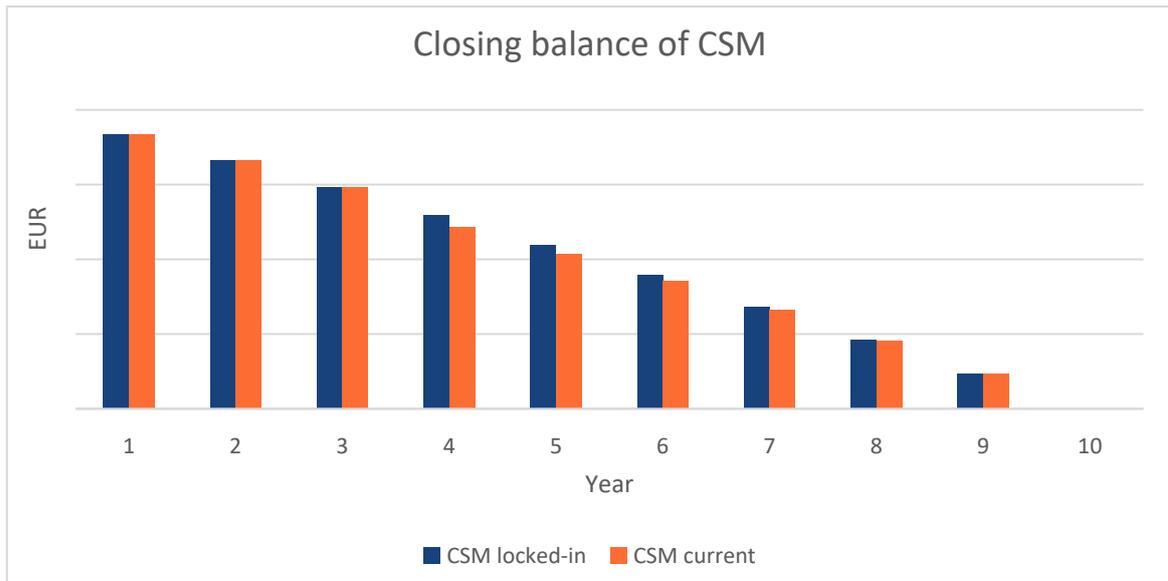


Fig 6 – Impact on closing balance of CSM using locked-in rate versus current rate for CSM accretion

- 44. Regarding Figure 6 above, as from year 4, the CSM when using current rates is lower compared to when using a locked-in rate as increasing the discount rate lowers the liability amount (including the total CSM).
- 45. The impact on equity over time as a result of an increase in discount rate could be as follows:

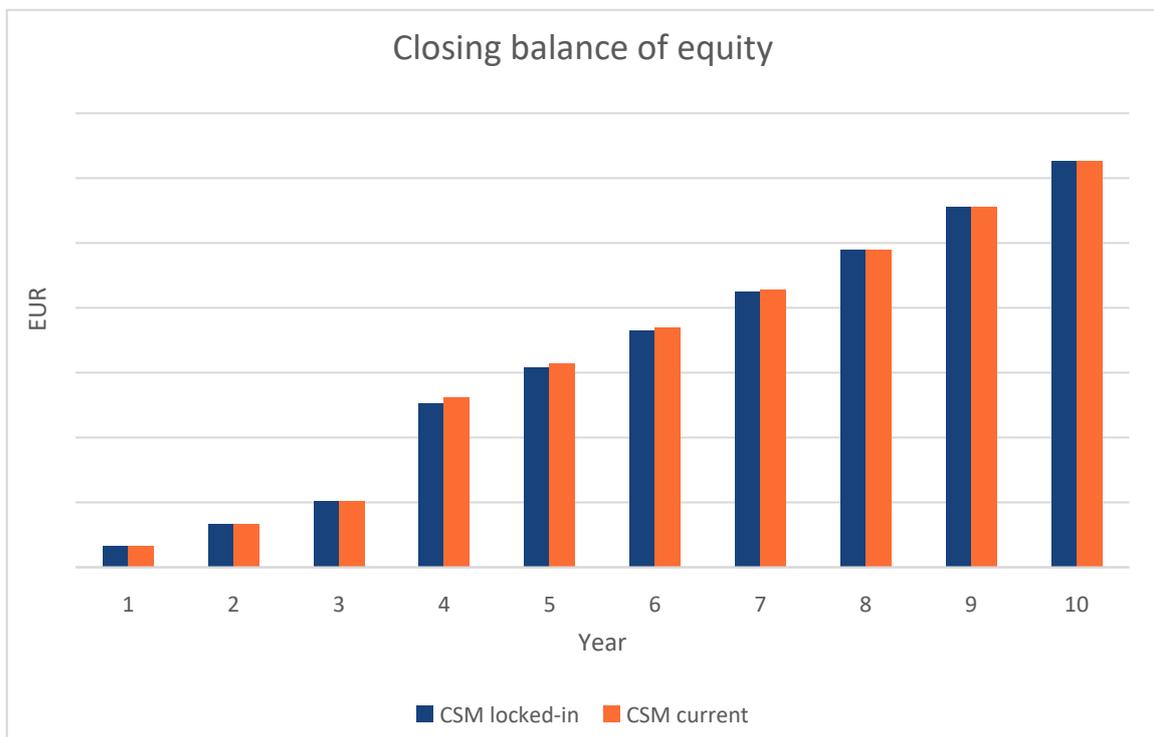


Fig 7 – Impact on equity using locked-in rate versus current rate for CSM accretion

- 46. As from Year 4, there is a higher equity value reflecting the decrease in the fulfilment cash flows due to the impact of the change in rate. The equity value using a current rate for the CSM is higher compared to using a locked-in rate due to the decrease of the total CSM amount. This reverses over time as the cohort reaches maturity.

## Feedback requested

1. Please provide feedback on whether the allocation patterns of CSM under the general model and for insurance contracts with direct participating features reflect the business model of the insurance sector? Please explain your answer.
2. Please provide your comments on the contractual service margin and its allocation to profit or loss that should be included in the draft endorsement advice on IFRS 17. Please answer in terms of:
  - Relevance (i.e. information that help users to evaluate events; or to confirm or correct their past evaluations; or helping the assessment of the stewardship of management);
  - Reliability (i.e. information free from material error and bias; resulting in faithful representation and is complete within the bounds of materiality and cost);
  - Comparability (i.e. consistent accounting for like items and events through time and by different entities, and the opposite for unlike items and events);
  - Understandability (i.e. financial information should be readily understandable by users with a reasonable knowledge and the willingness to study the information with reasonable diligence);
  - Prudence (i.e. caution in conditions of uncertainty. It may require asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated); and
  - Costs and benefits.
3. Referring to paragraphs 33 to 42 above, do you think the use of annual cohorts is operational? Please explain.
4. In case you consider that the use of annual cohorts is not operational, please explain how in your view maturity and profitability of a group of insurance contracts can provide relevant and reliable information.

## Appendix 1: Extracts from IFRS 17 relating to CSM

### Contractual service margin

- 38** The contractual service margin is a component of the asset or liability for the group of insurance contracts that represents the unearned profit 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.
- 39 For insurance contracts acquired in a transfer of insurance contracts or a business combination, an entity shall apply paragraph 38 in accordance with paragraphs B93–B95.

### Contractual service margin (paragraphs B96–B119)

- 43** The contractual service margin at the end of the reporting period represents the profit in the group of insurance contracts 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.
- 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.
- 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) 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.
- 46 Some changes in the contractual service margin offset changes in the fulfilment cash flows for the liability for remaining coverage, resulting in no change in the total carrying amount of the liability for remaining coverage. To the extent that changes in the contractual service margin do not offset changes in the fulfilment cash flows for the liability for remaining coverage, an entity shall recognise income and expenses for the changes, applying paragraph 41.

#### Changes in the carrying amount of the contractual service margin for insurance contracts without direct participation features (paragraph 44)

- B96 For insurance contracts without direct participation features, paragraph 44(c) requires an adjustment to the contractual service margin of a group of insurance contracts for changes in fulfilment cash flows that relate to future service. These changes comprise:
- (a) experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the discount rates specified in paragraph B72(c);
  - (b) changes in estimates of the present value of the future cash flows in the liability for remaining coverage, except those described in paragraph B97(a), measured at the discount rates specified in paragraph B72(c);
  - (c) differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period, measured at the discount rates specified in paragraph B72(c); and
  - (d) changes in the risk adjustment for non-financial risk that relate to future service.
- B97 An entity shall not adjust the contractual service margin for a group of insurance contracts without direct participation features for the following changes in fulfilment cash flows because they do not relate to future service:
- (a) the effect of the time value of money and changes in the time value of money and the effect of financial risk and changes in financial risk (being the effect, if any, on estimated future cash flows and the effect of a change in discount rate);
  - (b) changes in estimates of fulfilment cash flows in the liability for incurred claims; and
  - (c) experience adjustments, except those described in paragraph B96(a).
- B98 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.
- B99 An entity shall use that specification to distinguish between the effect of changes in assumptions that relate to financial risk on that commitment (which do not adjust the contractual service margin) and the effect of discretionary changes to that commitment (which adjust the contractual service margin).
- B100 If an entity cannot specify at inception of the contract what it regards as its commitment under the contract and what it regards as discretionary, it shall regard its commitment to be the return implicit in the estimate of the fulfilment cash flows at inception of the contract, updated to reflect current assumptions that relate to financial risk.

#### Changes in the carrying amount of the contractual service margin for insurance contracts with direct participation features (paragraph 45)

- B101 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).
- B102 An entity shall assess whether the conditions in paragraph B101 are met using its expectations at inception of the contract and shall not reassess the conditions afterwards, unless the contract is modified, applying paragraph 72.
- B103 To the extent that insurance contracts in a group affect the cash flows to policyholders of contracts in other groups (see paragraphs B67–B71), an entity shall assess whether the conditions in paragraph B101 are met by considering the cash flows that the entity expects to pay the policyholders determined applying paragraphs B68–B70.
- B104 The conditions in paragraph B101 ensure that insurance contracts with direct participation features are contracts under which the entity’s obligation to the policyholder is the net of:
- (a) the obligation to pay the policyholder an amount equal to the fair value of the underlying items; and
  - (b) a variable fee (see paragraphs B110–B118) that the entity will deduct from (a) in exchange for the future service provided by the insurance contract, comprising:
    - (i) the entity’s share of the fair value of the underlying items; less
    - (ii) fulfilment cash flows that do not vary based on the returns on underlying items.
- B105 A share referred to in paragraph B101(a) does not preclude the existence of the entity’s discretion to vary the amounts paid to the policyholder. However, the link to the underlying items must be enforceable (see paragraph 2).
- B106 The pool of underlying items referred to in paragraph B101(a) can comprise any items, for example a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity, as long as they are clearly identified by the contract. An entity need not hold the identified pool of underlying items. However, a clearly identified pool of underlying items does not exist when:
- (a) an entity can change the underlying items that determine the amount of the entity’s obligation with retrospective effect; or
  - (b) there are no underlying items identified, even if the policyholder could be provided with a return that generally reflects the entity’s overall performance and expectations, or the performance and expectations of a subset of assets the entity holds. An example of such a return is a crediting rate or dividend payment set at the end of the period to which it relates. In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set, and does not reflect identified underlying items.
- B107 Paragraph B101(b) requires that the entity expects a substantial share of the fair value returns on the underlying items will be paid to the policyholder and paragraph B101(c) requires that 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. An entity shall:
- (a) interpret the term ‘substantial’ in both paragraphs in the context of the objective of insurance contracts with direct participation features being contracts under which the entity provides investment-related services and is compensated for the services by a fee that is determined by reference to the underlying items; and
  - (b) assess the variability in the amounts in paragraphs B101(b) and B101(c):
    - (i) over the duration of the group of insurance contracts; and
    - (ii) on a present value probability-weighted average basis, not a best or worst outcome basis (see paragraphs B37–B38).
- B108 For example, if the entity expects to pay a substantial share of the fair value returns on underlying items, subject to a guarantee of a minimum return, there will be scenarios in which:
- (a) the cash flows that the entity expects to pay to the policyholder vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items do not exceed the fair value return on the underlying items; and
  - (b) the cash flows that the entity expects to pay to the policyholder do not vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items exceed the fair value return on the underlying items.

- The entity's assessment of the variability in paragraph B101(c) for this example will reflect a present value probability-weighted average of all these scenarios.
- B109 Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of IFRS 17.
- B110 For insurance contracts with direct participation features, the contractual service margin is adjusted to reflect the variable nature of the fee. Hence, changes in the amounts set out in paragraph B104 are treated as set out in paragraphs B111–B114.
- B111 Changes in the obligation to pay the policyholder an amount equal to the fair value of the underlying items (paragraph B104(a)) do not relate to future service and do not adjust the contractual service margin.
- B112 Changes in the entity's share of the fair value of the underlying items (paragraph B104(b)(i)) relate to future service and adjust the contractual service margin, applying paragraph 45(b).
- B113 Changes in the fulfilment cash flows that do not vary based on the returns on underlying items (paragraph B104(b)(ii)) comprise:
- (a) changes in estimates of the fulfilment cash flows other than those specified in (b). An entity shall apply paragraphs B96–B97, consistent with insurance contracts without direct participation features, to determine to what extent they relate to future service and, applying paragraph 45(c), adjust the contractual service margin. All the adjustments are measured using current discount rates.
  - (b) the change in the effect of the time value of money and financial risks not arising from the underlying items; for example, the effect of financial guarantees. These relate to future service and, applying paragraph 45(c), adjust the contractual service margin, except to the extent that paragraph B115 applies.
- B114 An entity is not required to identify the adjustments to the contractual service margin required by paragraphs B112 and B113 separately. Instead, a combined amount may be determined for some or all of the adjustments.

#### *Risk mitigation*

- B115 To the extent that an entity meets the conditions in paragraph B116, it may choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity's share of the underlying items (see paragraph B112) or the fulfilment cash flows set out in paragraph B113(b).
- B116 To apply paragraph B115, an entity must have a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts and, in applying that objective and strategy:
- (a) the entity uses a derivative to mitigate the financial risk arising from the insurance contracts.
  - (b) an economic offset exists between the insurance contracts and the derivative, ie the values of the insurance contracts and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity shall not consider accounting measurement differences in assessing the economic offset.
  - (c) risk does not dominate the economic offset.
- B117 The entity shall determine the fulfilment cash flows in a group to which paragraph B115 applies in a consistent manner in each reporting period.
- B118 If any of the conditions in paragraph B116 ceases to be met, an entity shall:
- (a) cease to apply paragraph B115 from that date; and
  - (b) not make any adjustment for changes previously recognised in profit or loss.

## Recognition of the contractual service margin in profit or loss

B119 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.

## Appendix 2: Extracts from IFRS 17 relating to other aspects

### Definitions

<p><b>insurance contract with direct participation features</b></p>	<p>An <b>insurance contract</b> for which, at inception:</p> <p>(a) the contractual terms specify that the <b>policyholder</b> participates in a share of a clearly identified pool of <b>underlying items</b>;</p> <p>(b) the entity expects to pay to the <b>policyholder</b> an amount equal to a substantial share of the fair value returns on the <b>underlying items</b>; and</p> <p>(c) the entity expects a substantial proportion of any change in the amounts to be paid to the <b>policyholder</b> to vary with the change in fair value of the <b>underlying items</b>.</p> <p style="text-align: right;">(IFRS 17 Appendix A)</p>
<p><b>investment contract with discretionary participation features</b></p>	<p>A financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:</p> <p>(a) that are expected to be a significant portion of the total contractual benefits;</p> <p>(b) the timing or amount of which are contractually at the discretion of the issuer; and</p> <p>(c) that are contractually based on:</p> <p style="padding-left: 20px;">(i) the returns on a specified pool of contracts or a specified type of contract;</p> <p style="padding-left: 20px;">(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or</p> <p style="padding-left: 20px;">(iii) the profit or loss of the entity or fund that issues the contract.</p> <p style="text-align: right;">(IFRS 17 Appendix A)</p>
<p><b>experience adjustment</b></p>	<p>(a) for premium receipts (and any related cash flows such as <b>insurance acquisition cash flows</b> and insurance premium taxes)—the estimate at the beginning of the period of the amounts expected in the period and the actual cash flows in the period; or</p> <p>(b) for insurance service expenses (excluding insurance acquisition expenses)—the estimate at the beginning of the period of the amounts expected to be incurred in the period and the actual amounts incurred in the period.</p> <p style="text-align: right;">(IFRS 17 Appendix A)</p>

## Level of aggregation of insurance contracts

- 22 An entity shall not include contracts issued 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.

## Onerous contracts

- 48 A group of insurance contracts becomes onerous (or more onerous) on subsequent measurement if the following amounts exceed the carrying amount of the contractual service margin:
- (a) unfavourable changes in the fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service; and
  - (b) for a group of insurance contracts with direct participation features, the entity's share of a decrease in the fair value of the underlying items. Applying paragraphs 44(c)(i), 45(b)(ii) and 45(c)(ii), an entity shall recognise a loss in profit or loss to the extent of that excess.
- 50 After an entity has recognised a loss on an onerous group of insurance contracts, it shall allocate:
- (a) the subsequent changes in fulfilment cash flows of the liability for remaining coverage specified in paragraph 51 on a systematic basis between:
    - (i) the loss component of the liability for remaining coverage; and
    - (ii) the liability for remaining coverage, excluding the loss component.
  - (b) any subsequent decrease in fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service and any subsequent increases in the entity's share in the fair value of the underlying items solely to the loss component until that component is reduced to zero. Applying paragraphs 44(c)(ii), 45(b)(iii) and 45(c)(iii), an entity shall adjust the contractual service margin only for the excess of the decrease over the amount allocated to the loss component.

## Derecognition

- 74 **An entity shall derecognise an insurance contract when, and only when:**
- (a) it is extinguished, ie when the obligation specified in the insurance contract expires or is discharged or cancelled; or**
  - (b) any of the conditions in paragraph 72 are met.**
- 75 When an insurance contract is extinguished, the entity is no longer at risk and is therefore no longer required to transfer any economic resources to satisfy the insurance contract. For example, when an entity buys reinsurance, it shall derecognise the underlying insurance contract(s) when, and only when, the underlying insurance contract(s) is or are extinguished.
- 76 An entity derecognises an insurance contract from within a group of contracts by applying the following requirements in IFRS 17:
- (a) the fulfilment cash flows allocated to the group are adjusted to eliminate the present value of the future cash flows and risk adjustment for non-financial risk relating to the rights and obligations that have been derecognised from the group, applying paragraphs 40(a)(i) and 40(b);
  - (b) the contractual service margin of the group is adjusted for the change in fulfilment cash flows described in (a), to the extent required by paragraphs 44(c) and 45(c), unless paragraph 77 applies; and
  - (c) the number of coverage units for expected remaining coverage is adjusted to reflect the coverage units derecognised from the group, and the amount of the contractual service margin recognised in profit or loss in the period is based on that adjusted number, applying paragraph B119.

## Cash flows within the contract boundary (paragraph 34)

- B65 Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:
- (a) premiums (including premium adjustments and instalment premiums) from a policyholder and any additional cash flows that result from those premiums.
  - (b) payments to (or on behalf of) a policyholder, including claims that have already been reported but have not yet been paid (ie reported claims), incurred claims for events that

have occurred but for which claims have not been reported and all future claims for which the entity has a substantive obligation (see paragraph 34).

- (c) payments to (or on behalf of) a policyholder that vary depending on returns on underlying items.
- (d) payments to (or on behalf of) a policyholder resulting from derivatives, for example, options and guarantees embedded in the contract, to the extent that those options and guarantees are not separated from the insurance contract (see paragraph 11(a)).
- (e) an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.
- (f) claim handling costs (ie the costs the entity will incur in investigating, processing and resolving claims under existing insurance contracts, including legal and loss-adjusters' fees and internal costs of investigating claims and processing claim payments).
- (g) costs the entity will incur in providing contractual benefits paid in kind.
- (h) policy administration and maintenance costs, such as costs of premium billing and handling policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract.
- (i) transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.
- (j) payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts.
- (k) potential cash inflows from recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent that they do not qualify for recognition as separate assets, potential cash inflows from recoveries on past claims.
- (l) an allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable to fulfilling insurance contracts. Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics.
- (m) any other costs specifically chargeable to the policyholder under the terms of the contract.

B66 The following cash flows shall not be included when estimating the cash flows that will arise as the entity fulfils an existing insurance contract:

- (a) investment returns. Investments are recognised, measured and presented separately.
- (b) cash flows (payments or receipts) that arise under reinsurance contracts held. Reinsurance contracts held are recognised, measured and presented separately.
- (c) cash flows that may arise from future insurance contracts, ie cash flows outside the boundary of existing contracts (see paragraphs 34–35).
- (d) cash flows relating to costs that cannot be directly attributed to the portfolio of insurance contracts that contain the contract, such as some product development and training costs. Such costs are recognised in profit or loss when incurred.
- (e) cash flows that arise from abnormal amounts of wasted labour or other resources that are used to fulfil the contract. Such costs are recognised in profit or loss when incurred.
- (f) Income tax payments and receipts the insurer does not pay or receive in a fiduciary capacity. Such payments and receipts are recognised, measured and presented separately applying IAS 12 *Income Taxes*.
- (g) cash flows between different components of the reporting entity, such as policyholder funds and shareholder funds, if those cash flows do not change the amount that will be paid to the policyholders.
- (h) cash flows arising from components separated from the insurance contract and accounted for using other applicable Standards (see paragraphs 10–13).

## Appendix 3: Assumptions used for the examples

### Fig. 1 – Allocation of CSM under the General model: expected terminations

1. Premiums of CU 2,000 paid at the start of each year and estimated claims of (i) CU 500 at end of year 2, (ii) CU500 at end of year 6 and (iii) CU 20,000 at end of year 10.
2. There is a fair value increase of the assets by 4% each year and assets are sold to pay the terminating events. Assets are accounted for as fair value through profit or loss.
3. Discount rate for the liability is 4% and there are no changes in discount rates over the coverage period. The profit or loss option is chosen for the finance expense.

### Fig. 2 – Allocation of CSM under the General model: unexpected terminations

1. The assumptions are the same as above except that:
  - a. At inception, there are only expected claims of CU 20,000 at end of year 10; and
  - b. However, unexpected claims occur as follows: (i) CU 500 at end of year 2, (ii) CU500 at end of year 6 resulting in an unexpected decrease in future premiums.

### Figures 3 – 5 Annual cohort examples

1. The following are assumptions used:

	No of contracts	CSM at inception (CU)	Duration (years)	Coverage units per year	Total coverage units
Cohort 1	20	2,000	10	20	200
Cohort 2	20	1,000	10	20	200
Cohort 3	20	300	10	20	200

2. Cohort 1 starts in Year 0, Cohort 2 starts in Year 5 and Cohort 3 starts in Year 7.
3. Expect that claims are paid at the end of the coverage period.
4. Each contract has the same quantity of benefits.
5. The coverage units are discounted to present value using 4% and there is no decrease in coverage units over the coverage period.
6. Accretion of CSM is based on 4%.

### Figures 6 and 7– Impact on closing balance of CSM using locked-rate versus current rate for CSM accretion

1. CSM of CU 2,000 at inception. There are no adjustments to CSM except for the CSM accretion.
2. Discount rate for the liability is 4% and this changes to 6% at the end of year 4. There are no further changes in discount rates over the coverage period.
3. The annual CSM release under the locked-in rate is treated as notional cash flows and the net present value of these using the new discount rate result in the updated CSM balance.
4. The profit or loss option is chosen for the finance expense.