Canadian Institute of Actuaries | Institut canadien des actuaires

Draft Educational Note

Application of IFRS 17 Insurance Contracts

Document 219020

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Standards and Guidance Council

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The actuary should be familiar with relevant educational notes. They do not constitute standards of practice and are, therefore, not binding. They are, however, intended to illustrate the application of the Standards of Practice, so there should be no conflict between them. The actuary should note however that a practice that the educational notes describe for a situation is not necessarily the only accepted practice for that situation and is not necessarily accepted actuarial practice for a different situation. Responsibility for the manner of application of standards of practice in specific circumstances remains that of the members.

MEMORANDUM

To: Members in the Life Insurance, Property and Casualty Insurance, and Workers' Compensation areas

From: Faisal Siddiqi, Chair
Standards and Guidance Council

Date: February 19, 2019

Subject: **Draft Educational Note: Application of IFRS 17 Insurance Contracts**

International Financial Reporting Standard 17 (IFRS 17) will be effective in Canada on January 1, 2021 (tentatively deferred by the International Accounting Standards Board to January 1, 2022).

In preparation for this new standard, the Standards and Guidance Council (SGC) has reviewed the exposure draft of the International Actuarial Note 100 (IAN 100) by the International Actuarial Association (IAA), and has decided to release it as a draft educational note to assist CIA members in the application of IFRS 17. Since IAN 100 was originally published by the IAA, it is presented in a different format and may use different terminology than that used in the Standards of Practice and educational notes developed by the CIA. Nevertheless, the SGC has decided to release the document without modification.

This draft educational note addresses each of the main topics of IFRS 17 and offers practical examples of ways in which actuaries might implement the standard. It will be supplemented by Canadian-specific guidance being developed by various CIA practice committees. Additional information about the IFRS 17 related activities of these committees can be found on the CIA IFRS 17 blog (login required).

In accordance with the CIA Policy on Due Process for the Approval of Guidance Material Other than Standards of Practice and research Documents, this draft educational note received final approval for distribution by the SGC on February 12, 2019.

Due to the length of the document and the time-sensitive nature of the information, and in accordance with the exemptions section of the Bilingualism Policy, the President of the CIA granted an exemption from publishing the French version of the IAN 100 simultaneously with the English version. The translation is underway, and a French version will be released as soon as practicable.

The actuary should be familiar with relevant educational notes. They do not constitute standards of practice and are, therefore, not binding. They are, however, intended to illustrate the application of the Standards of Practice, so there should be no conflict between them. The actuary should note however that a practice that the educational notes describe for a situation is not necessarily the only accepted practice for that situation and is not necessarily accepted

actuarial practice for a different situation. Responsibility for the manner of application of standards of practice in specific circumstances remains that of the members.

The IAA invites comments to be submitted to them by no later than April 26, 2019. The CIA and the Actuarial Standards Board intend to submit a joint comment letter to the IAA, including consideration of comments and suggestions from CIA practice committees involved in the development of IFRS 17 related guidance.

If you have any questions or comments regarding this process, please contact Faisal Siddiqi, chair of the SGC, at his CIA Online Directory address, Faisal.siddiqi@ca.ey.com.

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Introduction

This IAN has been written to assist actuaries in complying with IFRS17 and ISAP 4, by offering practical examples of ways in which actuaries might implement the ISAP and IFRS 17 in the course of their work. This IAN is organised into four sections and 15 self-standing chapters, discussing the main topics of IFRS 17. Each section has a brief introduction to the topics contained in that section. It is written as a series of questions and answers.

This IAN is based on the standard issued in May 2017 and also reflects some of the discussions held at the February and May 2018 Transition Resource Group (TRG) meetings. In chapter 12 (Transition) we have based the illustrative dates on an assumed date of initial application of January 1, 2022 as proposed by the IASB in November 2018. This document will be revised in the future to reflect any future changes to the standard by the IASB and discussions held at future TRG meetings.

What are International Financial Reporting Standards?

International Financial Reporting Standards (IFRS[1]), as issued by the International Accounting Standards Board (IASB), are intended to serve as guidance for developing general purpose financial statements and other financial reporting on a globally accepted basis.[2] General purpose financial statements are an important source of information for investors and other users to make economic decisions.

IFRS are focused on general purpose financial statements of consolidated groups of enterprises but are equally applicable to single societies or companies, be they profit-oriented entities or not-for-profit organizations such as mutual insurance companies. Financial reports in compliance with IFRS (IFRS reports) may be prepared voluntarily or their provision may be required, e.g., by state or stock exchange regulations. To be able to make an explicit and unreserved statement of compliance with IFRS, the financial report needs to comply with all requirements of the relevant IFRS.[3] The contents of a complete IFRS report are determined in IAS 1.10.

Some IFRSs are generally applicable (e.g., IAS 1 and IAS 8), some refer to specific circumstances (e.g., IAS 27, IAS 34, IFRS 1, or IFRS 10) while others refer to specific subjects (e.g., IAS 19, IAS 37, IFRS 9, IFRS 15, or IFRS 17) and are accordingly of more or less relevance for specific activities within the preparation of an IFRS report, but considering the need to be in compliance with all IFRS as noted before.

[1] IFRS refers to the ensemble composed by each individual international financial reporting standard (IFRS), as issued by the IASB since 2001, and by each individual International Accounting Standard (IAS), as issued by IASB's predecessor IASC before 2001, by each International Financial Reporting Interpretation Committee Interpretation (IFRIC), as issued by IFRIC, and by each individual Standard Interpretation Committee Interpretations (SIC), as issued by IFRIC's predecessor SIC. All these terms are registered trademarks owned by the IFRS Foundation, owning as well the copyright of all IFRS.

[2] IASB, Preface to International Financial Reporting Standards (PRE), September 2010, PRE.6–7.

[3] PRE.15 and IAS 1.16.

What is IFRS 17– Accounting for Insurance Contracts?

The project to develop authoritative guidance for accounting for insurance contracts in IFRS reports began in 1997. After introducing an interim standard, IFRS 4, in 2002, applicable from 2004 onwards, which allowed a wide scope of accounting approaches to continue to be applied, the IASB completed the project in 2017 by issuing *IFRS 17 Insurance Contracts*. IFRS 17 may be applied from 2018 onwards under certain conditions and is to be applied for all periods commencing after January 1, 2021, at the latest.

IFRS 17 provides authoritative guidance whether or to what extent items are within the scope of IFRS 17 (subsequently referred to as "classification") and about recognition, measurement, presentation and disclosure of items within the scope of IFRS 17. IFRS 17 covers insurance contracts, whether issued directly or acquired in the form of reinsurance contracts assumed by the entity. Rights and obligations of policyholders of direct insurance contracts are not within the scope of IFRS 17.

The scope of IFRS 17 refers mainly to insurance contracts, as defined in IFRS 17, as contracts transferring significant insurance risk, irrespective of the laws or regulation of the respective jurisdiction which might classify and regulate other contracts as insurance contracts. Special inclusions or exclusions of some forms of contracts which might meet the defining criteria are provided. Investment contracts with discretionary participation features are also covered by IFRS 17.

Recognition follows typical accounting practice but permits the recognition of future premiums in some cases, where they do not represent a current enforceable right of the entity. For that purpose, IFRS 17 introduces a concept referred to as contract boundary (see chapter 2) describing whether a future non-enforceable premium might be anticipated or not in the liability determination.

How is the liability for an insurance contract determined?

The measurement under IFRS 17 requires the determination of a current value of the insurance contract, considering market perspectives for financial risks and the reporting entity's perspective for all other risks, in IFRS 17 referred to as the fulfilment cash flows. This current value is the basis of the measurement of the insurance contract and is to be disclosed. The disclosures include its conceptual parts, the unbiased estimate of the expected present value of future cash flows, which is adjusted for the time value of money and further adjustments applied for financial risks and non-financial risks.

At the outset a contractual service margin (CSM) is established to offset any gain, if any, at initial measurement – that is, the value of premiums in excess of the value of obligations. This is then recognized as revenue over the period providing coverage. While there is no unit of account defined for the fulfilment cash flows, the unit of account for the CSM are partitions of annual cohorts, based on at least three different profitability categories, which are part of annual new business and form the unit of account of the CSM.

The described main approach of IFRS 17 is referred to in this IAN as general measurement approach (GMA). IFRS 17 allows for a simplified alternative approach to be used for contracts of

short coverage period (typically not more than 12 months), known as the premium allocation approach (PAA). The PAA is similar to the unearned premium method in that the measurement of the liability for remaining coverage of short duration contracts might be simplified by distributing premiums over the coverage period in line with passage of time or in proportion to expected benefits. The PAA only applies to the part of the total measurement of the contract referred to as liability for remaining coverage, with the liability of incurred claims following the GMA.

Some special guidance applies for certain contracts whose benefits are determined based on indices or other underlying items like surplus (i.e., insurance contracts with direct participation features) sometimes referred to as the variable fee approach (VFA). It includes a feature distributing the insurer's share in changes of financial risk and incurred events over the remaining coverage period of the contract.

Reinsurance ceded is measured using assumptions that are consistent with the ceded contract.

How do insurers present profit or loss statements when applying IFRS 17?

The statement of financial performance (profit or loss) is expanded by a section for the insurance service result. This contains as insurance revenue any release of cash flows, except those from investment components, risk adjustments for non-financial risk, and CSM from the liability for remaining coverage for the respective period as far as originally resulting from premiums. Actual benefits and expenses of the period, including changes in the liability for incurred claims, but excluding any investment component paid, are presented as insurance service expenses. Changes in the effect of discounting and any other effect of financial risk are presented as insurance finance revenue or insurance finance expenses in the financial result. There is an accounting policy choice to present the effect of changes of financial risk directly in equity (other comprehensive income), potentially avoiding/reducing volatility in the statement of financial performance.

Which specific disclosure requirements are included in IFRS 17?

IFRS 17 includes requirements to disclose information about the amounts recognized in the IFRS report, particularly requiring reconciliations of presented amounts, significant judgment in determining those figures, including disclosures of the applied interest rate curves and a quantification of the risk adjustment for non-financial risk, and the nature and extent of the risks from the covered contracts.

In applying IFRS 17 for the first time, the standard provides two alternative approaches for transition if the retrospective approach as required by IAS 8 is impracticable. These are a modified retrospective approach and a fair value approach.

There is not a separate chapter on disclosure in this IAN. Rather, disclosure is discussed in various chapters as relevant.

References to IFRS17

In this IAN the use of the phrase "paragraph X" etc. is a reference to paragraphs in IFRS 17. Where paragraphs from other IAS/IFRS are referenced (e.g., paragraph 28 of IFRS13) then that international standard is stated.

In conjunction with IFRS 17, the IASB has published illustrative examples to IFRS 17. The document contains 18 examples applying IFRS 17 to hypothetical situations. Paragraph numbers in the illustrative examples to IFRS 17 are prefixed "IE".

Interpretations are issued from time to time by the IASB Interpretations Committee (IFRIC). At the time of drafting this IAN there are no interpretations relating to IFRS 17 but one or more could be issued in the future.

In this IAN reference is sometimes made to "BC" paragraphs from the IASB "Basis for Conclusions" which accompanied IFRS17 when it was published. Those paragraphs together with any staff papers issued for TRG meetings, which are also referred to in this IAN, should not be considered as authoritative guidance. Rather they may be considered as background or supporting material.

Materiality

Materiality, in an accounting sense, is a principle that essentially creates a boundary between issues that have an effect on the outcome in an accounting sense and those that have no discernable effect. Judgment is required in determining this boundary which affects that scope and extent of actuarial analysis for the GMA.

The following comes from paragraph 2.4 of ISAP 1:

In case of omissions, understatements, or overstatements, the actuary should assess whether or not the effect is material. The threshold of materiality under which the work is being conducted should be determined by the actuary unless it is imposed by another party such as an auditor or the principal. When determining the threshold of materiality, the actuary should:.

- *Assess materiality from the point of view of the intended user(s), recognizing the purpose of the actuarial services; thus, an omission, understatement, or overstatement is material if the actuary expects it to affect significantly either the intended user's decision-making or the intended user's reasonable expectations;*
- *Consider the actuarial services and the entity that is the subject of those actuarial services; and*
- *Consult with the principal if necessary.*

Proportionality

Proportionality, in an accounting sense, is a principle that determines that the appropriate weights are given to all influences on accounting measures. Again, actuarial judgment has a major influence.

Illustrative Examples

In this IAN some examples are provided to help ease of understanding of the topic. It should be remembered that these examples are for illustrative purposes only and each case needs to be considered on its own merits.

Overview of the Sections and Chapters of this IAN for IFRS 17

Chapter 1 on Classification of Contracts and Contract Boundaries

This chapter considers approaches to the classification required by IFRS 17, including the identification of contracts, the scope of IFRS 17, and contract boundaries. It refers to other IANs addressing further specific classifications.

Section A – The General Measurement Approach

Chapter 2 on Estimates of Future Cash Flows

This chapter considers the requirements for determining the estimates of future cash flows whether they be to calculate liabilities for remaining coverage or liabilities for incurred claims. It discusses issues such as which cash flows would typically be included, how those cash flows might be estimated, how the term "current estimate" is defined, or what does it mean to be unbiased. The chapter also refers the reader to the IAA's monographs on current estimates[4] and on stochastic modelling[5]. This chapter does not discuss the cash flows particular to contracts with participating features or other variable cash flows which are discussed in chapter 8.

Chapter 3 on Discount Rates

This chapter considers the time value of money in the measurement of future cash flows and financial risk. It discusses both the "top down" and "bottom up" approaches referred to in IFRS 17 for determining yield curves. The chapter refers to the estimation of risk-free rates, the decomposition of credit and liquidity risks, extrapolation of yield curves, and investment-related expenses. The roles of the discount rate in the measurement of cash flows varying with underlying items, the determination of interest expense and the interest to be accreted on the CSM are also considered.

Chapter 4 on Risk Adjustment for Non-Financial Risks

This chapter considers the criteria for, and measurement of, the risk adjustment for non-financial risk required as part of the general measurement approach under IFRS 17 including the purpose and general requirements of the risk adjustment, what risks would typically be covered, and specific considerations in determining the risk adjustment. This note discusses how to reflect risk mitigation as risk mitigation in a pool, diversification, risk sharing, catastrophic and other infrequent events, qualitative risks considerations, use of different approaches by line of business, and general considerations in selecting and calibrating a risk adjustment approach. For detailed risk adjustment methods and how to apply them, reference is made to the IAA monograph risk adjustments [6]. This chapter also covers high-level disclosure requirements including confidence level disclosure, and issues around allocation of risk adjustments to a lower level.

[4] *Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins*
[5] *Stochastic Modelling – Theory and Reality from an Actuarial Perspective*
[6] *Risk Adjustments under IFRS 17*

Chapter 5 on Unit of Account

This chapter considers the appropriate level of aggregation when accounting for business under IFRS 17. Amongst other considerations this includes the determination of the unit of account and the setting of portfolios and groups to meet IFRS 17 needs.

Chapter 6 on Contractual Service Margin and Loss Component

This chapter considers the requirement under IFRS 17 to set up a contractual service margin (CSM) at outset for each group of insurance contracts, including how it should be determined, the subsequent measurement, including the allocation of revenue to future periods in line with the provision of services, and the treatment of the loss component for "onerous contracts".

Section B – Variations to the GMA

Chapter 7 for Premium Allocation Approach

This chapter considers the use of the premium allocation approach (PAA) under IFRS 17 including the criteria to be met for an insurance contract to choose this method, the measurement approach, and the differences between this approach and the general measurement approach. The chapter focuses on the "liability for remaining coverage". The measurement of the contract liability from the point of occurrence of an insured event includes the "liability for incurred claims" which follows the requirement of the general measurement approach discussed in other chapters.

Chapter 8 on Participation Features and Other Variable Cash Flows

This chapter considers the recognition, measurement and presentation of participating features, particularly in the case of contracts with direct participation features, as well as for other cash flows subject to the discretion of the insurer or linked to indices, including the criteria to be met for those classifications.

Chapter 9 on Reinsurance

This chapter considers the treatment of reinsurance, both held (ceded) and assumed, under IFRS 17, including how to determine if IFRS 17 is applicable to specific reinsurance transactions. It discusses issues related to the separate presentation and valuation of the reinsurance ceded from associated underlying (ceded) contracts, and considerations in determining the estimate of future cash flows, risk adjustments and CSM and allowance for counter party risk on reinsurance ceded. Similar issues are covered for reinsurance assumed.

Section C – Uses of Fair Value Measurement in IFRS 17

Chapter 10 on Fair Value Measurement

This chapter considers the use of the fair value measurement of insurance contracts for IFRS 17 including for business combinations or portfolio transfers and on transition if the fair value approach is chosen.

It discusses the determination of the fair value of insurance contracts in the context of the more general guidance on fair value measurement found in *IFRS 13 Fair Value Measurement* and of common insurance industry practices.

Chapter 11 on Business Combinations and Portfolio Transfers

This chapter considers the requirements under IFRS 17 when accounting for insurance contracts or liabilities for incurred claims acquired in a business combination or a portfolio transfer, and in particular the need to use the fair value of the contracts as the initial consideration. This chapter considers the interaction between IFRS 17 and the more general guidance found in *IFRS 3 Business Combinations* and discusses aspects of business combinations, such as the determination of goodwill and the recognition of intangible assets.

Chapter 12 – Transition

This chapter considers the one-time event of presenting statements applying IFRS 17 for the first time. It has four sections: an overview and then a section for each of the three transition methods described in IFRS 17 – the retrospective approach of IAS 8 and the alternative approaches introduced by IFRS 17, modified retrospective and fair value. The chapter has a sample timeline. It also references content from chapter 15 on fair value measurement.

Section D – Other IFRS 17 Topics

Chapter 13 on Embedded Derivatives

This chapter considers the requirements under IFRS 17 for the separation of certain derivatives embedded in contracts subject to the scope of IFRS 17. This chapter discusses the issues that may arise in detecting and identifying embedded derivatives in such contracts which may need to be separated. Further information about embedded derivatives based on other IFRS is found in the existing IAN 10 embedded derivatives.

Chapter 14 on Contract Modifications

This chapter considers the treatment under IFRS 17 of contract modification to insurance contracts, including reinsurance contracts, derecognition, and transfer to third parties. It discusses what constitutes a contract modification and what can be simply treated as a change in estimate.

The chapter describes approaches for determining the deemed premium when treated as a cancellation, and replacement of the original contract as well as the application under the PAA. The approaches applicable to future contractual cash flows to be considered due to a prior contract boundary are also outlined.

It also discusses when and how contracts can be derecognised.

Chapter 15 on Measurement, Presentation and Disclosures

This chapter considers the general requirements for presentation of financial information under IFRS contained in IAS 1 as well as the specific additional requirements in IFRS 17. It also provides general comments on the disclosures required to explain the presentation such as the required reconciliations. Additionally, this chapter discusses the additional requirements of IFRS 17, including what constitutes revenue and expenses, how experience variances are presented, what is to be reported in the statement of financial performance versus other comprehensive income, the level of aggregation to be used in presentation and disclosure, and required reconciliations.

Chapter 1 – Classification of Contracts

Before consulting this chapter, be sure to read the Introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

1 A. What does this chapter address?

This chapter considers the scope of IFRS 17, the identification and boundary of insurance contracts, separation of components and combination contracts and level of aggregation under IFRS 17 and contract boundaries. It refers to other IANs addressing further specific classifications.

1.B. Which sections of IFRS 17 address this topic?

Paragraphs 2-25, 34-35, 62, 72-74, appendix A, paragraphs B3-5, B7-18, B24-27, B31-32, and B61, B64, C10, C21, and C23 provide guidance on this topic.

BC 22, BC42-44, BC79, BC85, BC100, BC114, BC117, BC119, BC136, and BC160 also provide background on the subject.

1.C. What other IAA documents are relevant to this topic?

None

Scope of IFRS 17

1.1. Which contracts are covered under IFRS 17?

Paragraph 3 states that the contracts within the scope of the standard are:

a) Insurance contracts (including reinsurance contracts) an entity issues;

b) Reinsurance contracts an entity holds;

c) Investment contracts with discretionary participation features any entity issues, provided the *entity also issues insurance contracts.*

The definition of an **insurance contract** is the same as under IFRS4 and can be found in appendix A of IFRS 17.

"*A contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."*

Insurance contracts held by an entity (i.e., as a policyholder), which are not reinsurance contracts held, are not, however, within the scope of IFRS 17 (see paragraph 7(g)).

While IFRS 4 used the phrase "*financial instruments with discretionary participation features"*, IFRS 17 refers instead to *"investment contracts with discretionary participation features"*. The definition of this term in appendix A refers in turn to "financial instruments" and so is very similar to that used in IFRS 4.

Appendix A defines "i*nvestment contracts with discretionary participation features*" as

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:

(a) that are expected to be a significant portion of the total contractual benefits;

(b) the timing or amount of which are contractually at the discretion of the issuer; and

(c) that are contractually based on:

(i) the returns on a specified pool of contracts or a specified type of contract;

(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

(iii) the profit or loss of the entity or fund that issues the contract.

1.2. What is the definition of an insurance risk under IFRS 17?

As noted in 1.1 above, appendix A of IFRS 17 defines an insurance contract in terms of acceptance of "*significant insurance risk*".

Insurance risk is defined in Appendix A of IFRS 17 as *risk, other than financial risk, transferred from the holder of the contract to the issuer*.

Paragraphs B7 to B16 provide guidance on what is insurance risk when applying this definition.

Financial risk as defined in Appendix A of IFRS 17, includes non-financial variables, provided they are not specific to the insurer or policyholder. Paragraph B8 explains this and provides examples.

Even if a financial variable is used in determining the size of a payment, if the payment is significant and dependent upon the occurrence of an insured event, then the contract is an insurance contract (see paragraph B10). An example of this is an index-linked life insurance cover where the insured death benefit is the difference between the value of the units and the specified death benefit.

An insured event is defined in appendix A of IFRS 17 as "*An uncertain future event covered by an insurance contract that creates insurance risk.*"

Paragraphs B3 to B5 provide guidance on what "*an uncertain future event*" is when applying this definition.

The uncertainty can relate to one or more of the probability, timing or size of the event. Hence, it includes cases where the event has already occurred, but the timing or size of the compensation remains uncertain.

The insurance risk must have an adverse effect on the policyholder and is transferred to the insurer by the insurance contract. Therefore, the policyholder should be already exposed to this risk before the insurance contract is created (see paragraph B11). Lapse, persistency and contract expense risks arising from a contract are for the reasons above not insurance risks.

A contract issued to an entity that covers risks such as lapse, persistency or contract expenses on that entity's existing portfolio is likely to meet the definition of an insurance contract for the issuer since the entity is the policyholder. Further, if the entity's existing portfolio includes insurance contracts, not just investment contracts, then such a contract is also likely to qualify as reinsurance held, for the holder of the contract. If there are no insurance policies in the portfolio, the contract does not fall under IFRS 17 for the entity (see paragraphs B14 and B15).

This adverse effect of the uncertain event on the policyholder is a necessary contractual precondition for a contract to meet the definition of an insurance contract. Note this does not require the insurer to investigate if an adverse effect occurred, but just to have the ability to deny compensation if such adverse effect does not exist (see paragraph B13).

The compensation can be a payment in kind by providing goods or services (see question 1.4).

1.3. What is the definition of significant insurance risk?

An insurance contract is only in scope of IFRS17 if it transfers a significant amount of insurance risk to the entity (or reinsurer).

Insurance risk is only significant if there is at least one scenario with commercial substance where the compensation paid by the insurer is significant, disregarding the likelihood of that scenario. If commercial substance exists only in very unlikely scenarios, but the contract covers all these scenarios then this qualifies as being significant (see paragraph B18).

Insurance risk can already be significant even if the policyholder still has to opt for insurance cover in the future, but with insurance rates already specified. Also, an insurance contract remains an insurance contract even if the original insurance risk has expired (unless a specified contract modification has occurred (see paragraphs 72 and 74-77).

IFRS 17 requires that the compensation and its commercial substance be considered on a present value basis, unlike IFRS 4, which did not require the use of present values in making this assessment.

1.4. What are examples of contracts that are covered under IFRS 17?

Paragraph B26 gives a list of examples. Most of the items on the list were also on the one in IFRS 4.

Some contracts may not fall under IFRS 17, even though they involve significant transfer of insurance risk. For example:

- Product warranties may otherwise qualify as insurance contracts, but not when issued directly by the manufacturer. These fall under IFRS 15 or IAS 37.
- Life-contingent annuities and pensions may otherwise qualify as insurance contracts, but not when accounted for as part of employers' liabilities from an employee benefits plan or retirement plan. These fall under IAS 19 or IAS 26.

In addition, for some contracts that meet the definition of an insurance contract, but whose primary goal is to provide services for a fixed fee, paragraph 8 gives entities the option to choose between IFRS 17 and IFRS 15, if the contract meets all of the following criteria:

- the entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;
- the contract compensates the customer by providing services, rather than by making cash payments to the customer; and
- the insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services.

An example of this type of contract could be roadside assistance.

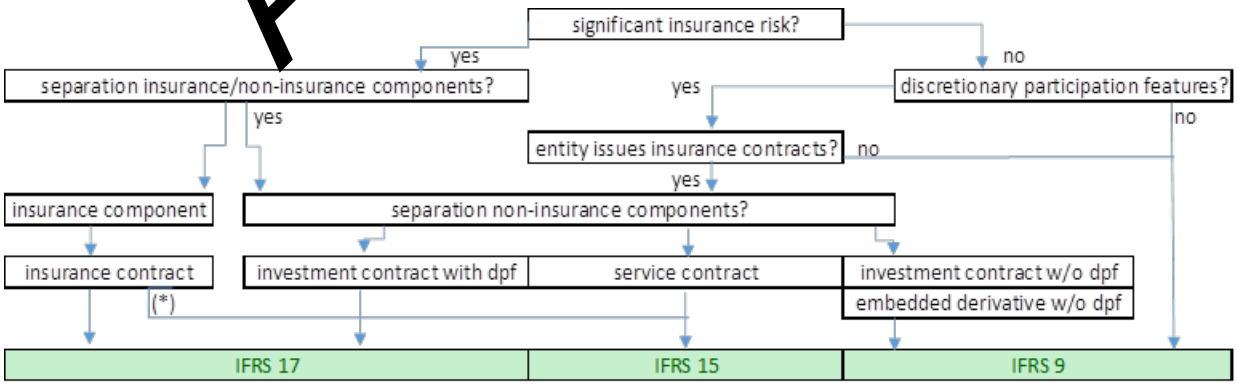
1.5. What are examples of contracts that are not covered under IFRS 17?

Paragraph 7 sets out contracts that are specifically excluded from the scope of IFRS 17 even if they meet the definition of an insurance contract. This list is similar to the one in IFRS 4; however, it also now explicitly excludes residual value guarantees provided by a manufacturer, dealer or retailer.

In addition, under paragraph 7(e), although financial guarantee contracts remain excluded from the scope of IFRS 17, it now allows an entity that has previously regarded such contracts as insurance contracts and applied insurance accounting on them, the option to use IFRS 17 for such contracts. Otherwise the IFRS relating to financial instruments apply (IFRS 7, 9 and 32).

Paragraph B27 provides examples of contracts that do not qualify as insurance contracts. These are unchanged from IFRS 4, although in some cases they have been expanded upon.

The following schematic helps understanding which contracts fall under IFRS 17 or elsewhere.



(*) IFRS17.8: optional for fixed fee service contracts

1.6. Where does the scope of IFRS17 differ from IFRS 4?

The examples in questions 1.4 and 1.5 already include a comparison with IFRS 4.

Under paragraph 3, investment contracts with discretionary participation features are only in scope if the entity also issues insurance contracts. This additional condition was not in IFRS 4. BC85 explains the rationale for this is that for the few entities that issue investment contracts with discretionary participation benefits, but not insurance contracts, the costs of implementing IFRS 17 would outweigh the benefits.

Separation of components from a contract

1.7. When might components of a contract be valued separately?

IFRS17 distinguishes between insurance components, embedded derivatives, investment components and service components (see paragraphs 10-13).

Embedded derivatives are to be separated following the rules of IFRS 9. Derivatives that can be contractually transferred independently, or have another counterparty, are not embedded, but separate contracts.

Investment components are to be separated if and only if they are distinct, which means that *both* of the following conditions are met (paragraphs B31 and B32):

- The investment component is not highly interrelated with the insurance component; this means both that the entity is able to measure each component without considering the other components and policyholders can benefit from each component even if the other is not present (e.g. each component can lapse independently).
- The investment component appears after some reasonable research to be, or could be, sold separately in the same market or jurisdiction.

This means for instance that components that necessarily expire together (in case of a death or lapse/cancellation) or that are available in other markets but could not be provided separately in the own market, in general would not be separated.

Service components are to be separated in line with paragraph 7 of IFRS 15, but only after satisfying the requirements of paragraphs B33-35, in which case they are measured under IFRS 15, as modified by paragraph 12 of IFRS 17. To separate service components, fulfilment cash in-flows and outflows need to be attributed to either the insurance or service component, with a rational allocation for those cash flows that are not uniquely related to either of these two (see paragraph.12).

1.8. What are examples of components that are currently often separated, but can no longer be separated under IFRS 17?

Insurers have currently often different components, such as claims liabilities to be settled, unearned premiums, receivables/payables, etc. managed separately and administered in different systems. IFRS 17 leads to insurance receivables, policy loans and reinsurance collateral (funds withheld) no longer being separately visible on the balance sheet.

BC114 gives policy loans, assuming that they are a contractual feature, as an explicit example of a component highly interrelated with the rest of the contract and therefore not separable in a non-arbitrary way.

Contract boundary

The contract boundary distinguishes future cash flows to be considered in the measurement of the insurance contract from other future cash flows, even if they are expected to be paid under the same contract (see paragraphs 34 and B61). The contract boundary determines where a contract ends for measurement purposes, for a reporting period.

1.9. What is the definition of a contract boundary under IFRS 17?

Paragraph 34 defines the boundary of a contract for IFRS 17 measurement purposes.

"Cash flows are within the boundary of an insurance contract 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."

1.10. What are "substantive rights and obligations"?

Paragraph 2 makes it clear that:

- rights and obligations arise from a contract, law, or regulation; and
- enforceability of the rights and obligations is a matter of law.

It applies the term "substantive" to identify when future cash flows arising from those rights and obligations can be recognised as assets or liabilities. Accordingly, all clear cases of present enforceable rights or present enforceable obligations, as discussed in BC160, are within the contract boundary, if they are substantive. Any terms that have no economic substance are disregarded.

According to paragraph 34, substantive rights and obligations "*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*".

Cases where no party has any right may be outside the contract boundary (see BC160 (a)). This is particularly the case if both parties have an unlimited cancellation right or no party has a renewal right.

If the policyholder cannot be forced to pay the premium, e.g., if the policyholder is not obliged to renew a contract with an agreed upon duration, there is no substantive right of the entity to premiums after the agreed duration.

A substantive obligation could be present in cases where the applicable terms and conditions can cause future cash flows, compared with alternative cash flows within the contract boundary or premium component, to be onerous without the insurer having the ability to avoid such losses due to the absence of any cancellation or premium or benefit adjustment right. In that case, the guidance of paragraph 34 is likely to require that the loss is anticipated.

For example, in the case of a contractual clause that the funds of the contract might be used to purchase an annuity where the assumptions regarding longevity could be adjusted to represent the individual longevity risk, but not beyond that, the annuity is

normally not within the contract boundary. If the terms and conditions determine a contractually fixed annuitisation rate, however, then the entity is likely to be subject to a substantive obligation and the loss-making annuitisation of the funds might be anticipated, considering the likelihood that the annuity will be elected. That might also apply in cases where a premium component, with a unilateral right of the policyholder to pay the premium in future, includes minimum financial guarantees that are in the money at the reporting date and the adjustment clauses would not allow the entity to avoid that loss if the policyholder decides to pay the premium.

Paragraphs 34 (a) and (b) describe two alternative cases of when a substantive obligation ends. Accordingly, to show that a future contractual cash flow is not a substantive obligation, it is necessary to demonstrate that it arises from (or after) a period for which one of the following cases apply:

a) the entity has the practical ability to reassess the risks of the particular policyholder and can set a price accordingly; or

b) both of the following conditions are satisfied:

   i) The entity has the practical ability to reassess the risks at a portfolio level and can reset the price or level of benefits accordingly; 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 future periods.

1.11. What does it mean to have the practical ability to reassess the risk?

The reference to the "practical ability" to reassess the risk is intended to differentiate from a pure formal legal right to do so, but where practical facts and circumstances actually prevent the entity from doing so. For example, it might be practically impossible to assess the risk due to any or all of the following:

- inaccessibility of the item bearing the risk;
- moral reasons;
- significant cost; or
- significant business dangers.

It is not the expectation that the entity does not intend to apply the reassessment but only the expectation that, even if it wishes to do so, it would not be able due to practical reasons.

Paragraph B64 notes that practicable ability exists if the entity can reprice the contract or portfolio (as applicable) to the same price it would charge for a new contract or portfolio with same characteristics. If an entity decides to charge a new price for new contracts, but for commercial reasons decides not to do so for existing contracts, then further judgment is required to assess whether this commercial decision was a free choice or refers to a practical inability to reprice. (see paper AP03 to May 18 TRG.)

1.12. What does it mean to reassess the risk of a particular policyholder?

When considering whether or not there is a substantive obligation, the entity may consider if there is any risk of anti-selection by the policyholder on the specific financial risk transfer. For instance, because of a possibly impaired risk profile it might be advantageous for the policyholder to continue the existing contract rather than effect a new contract. This advantage affects the substantive obligation of the entity to provide services.

The conditions outlined here might only be understood by considering the underlying risk for the "particular policyholder" and cannot be assessed based on collective information. Therefore, under paragraph 34 (a) this can be interpreted to refer to risks transferred from the policyholder, insurance and financial risk only. The substance of the obligation results from guaranteed insurability or minimum guarantees on participation contracts.

1.13. What does it mean to reassess the risks at a portfolio level?

This is more than the ability to reflect general market experience, it requires the ability to reflect the experience of the portfolio itself. Again, the risks being reassessed are policyholder risks, transferred from the policyholder, i.e., insurance and financial risks not lapse and expense risks created by the contract even though they would be reflected in pricing (see paper AP02 to February 2018 IASG).

1.14. When does an obligation take into account the risks that relate to future periods?

The condition in paragraph 34(b) refers to substantive obligations arising from premiums already paid in the past even in the case of a collective premium or benefit adjustment clause. If there are none, as outlined in paragraph 34 (b) (ii), there is no substantive obligation in this case. This is typically the case if the entity charges premiums only to finance services in the premium payment period and the premium or benefit adjustment clause refers to future premiums financing the services in future periods entirely without support from already paid premiums. If the entity charged premiums in the past which included parts intentionally considered to finance coverage together with future premiums, those past premiums result in a substantive obligation of the entity, even if the future premiums are subject to a collective premium or benefit adjustment clause.

Paragraph 34(b) reflects two of the common types of premiums:

a) those which are often referred to as "yearly renewable" that only cover the risk arising in the next period e.g., one year (no substantive obligation); and

b) level premiums for the whole contract which in any one year might be greater or less than the cost of the risk for that next year with any excess premium being used to help "finance" the cost of risk in a later period (substantive obligation).

1.15. What is the consequence if a future cash outflow is outside the contract boundary, but not the originating premium?

This situation occurs if the future benefits are to be provided in the form of another service, e.g., an investment contract with an option to purchase an annuity with proceeds

at maturity (see paragraph B24). In this case, the option to purchase an annuity, means the provision of an annuity is part of the contractual terms of the investment contract and it has significant insurance risk at inception. As noted in paragraph B24, however, if the contract as a whole is able to be repriced (as per paper AP03 to May 2018 TRG), which is the case here, when it becomes an annuity, and it is repriced to the then current terms for new entrants, then the annuity and associated provision of insurance coverage is outside the contract boundary. If terms of conversion to annuity are fixed at inception of the investment contract, the insurance coverage is within the boundary of the investment contract and the contract at inception, not just when annuity option is exercisable, is an insurance contract.

1.16. What are the issues for contract boundaries under reinsurance?

Paragraph 34 cannot be applied as it is, because in reinsurance held it is the entity who pays the premium (substantive obligation) and receives services (substantive right). In accordance with paragraph 4 (and TRG paper 3 of February 2018 and paper 4 of May 2018), the reading of this paragraph needs to be adapted appropriately to the context of reinsurance held. The contract boundary is then, the earlier of:

- when the reinsurer can reassess the services, thereby ending the substantive right of the holder of the reinsurance to receive the service; and
- the insurer is no longer compelled to pay a premium, thereby ending the substantive obligation.

When a direct insurance contract is being reinsured, differences in the boundaries of both contracts may occur, due to reinsurance and underlying insurance contracts having different dates of initial recognition. For example:

- A new reinsurance contract may cover insurance contracts that existed prior to the reinsurance contract coming into effect; or
- The scope of the reinsurance contract may extend to include future insurance contracts yet to be issued within the boundary of the reinsurance contract.

The February 2018 TRG meeting in its discussion of paper AP03, observed that expected future contracts could be within the boundary of the reinsurance contracts. Note, paragraph 62 only requires that a proportionate reinsurance should not be recognised earlier than the initial recognition of any underlying contract and does not determine the boundary of the reinsurance contract.

Also, reinsurance contracts sometimes provide the reinsurer with cancellation options that are more flexible than in direct insurance and care is needed in assessing the boundary of such a reinsurance contract.

1.17. What are other boundary situations that need separate consideration?

Paragraph 35 states that expected future cash flows, which are not within the contract boundary, relate to future contracts. The standard does not make a distinction between

the situation where such cash flows are highly interrelated with the existing contract, or not.

A typical situation is an insurance contract with a unit linked account and an insurance rider with the annual stepped rider premiums deducted from the unit linked account. As the units are repriced daily to market, they do not create a substantive obligation. If the rider premiums can be repriced at the portfolio level at annual renewal, then substantive obligation for insurance ends at annual renewal and boundary for the contract, as a whole, is the annual renewal date (see AP02 February 2018 TRG). In general, the cash flows arising from these future premiums are then considered as being outside the contract boundary.

Future insurance contracts

Under paragraph 35, future premiums, and the cash flows arising from them, would then relate to future contracts. Since contracts can be combined in groups issued no more than one year apart, this would mean that each set of annual premiums and associated cash flows would need to be treated as a separate contract under IFRS 17.

This has significant implications if the cash flows resulting from paid and future premiums are highly interrelated, for instance:

- Acquisition expenses for the contract as a whole: acquisition expenses are allocated to the initial contract created by premiums paid up to annual renewal, except to the extent they are dependent on renewal of the contract, e.g., acquisition commission subject to clawback if the contract is not renewed, can be allocated to the future contract created by the renewal (see AP04 February 2018 TRG). This could likely lead to an onerous "first" contract comprising the first premium only and to several very profitable contracts related to future premiums afterwards;
- In some instances, a rider cost may be funded from an investment component built by paid premiums. The risk premiums extracted from each "premium layer" contract will need to be reconsidered every time a new premium is paid.

Also, it may be technically possible that such "new" contracts are not in the scope of IFRS 17, e.g., right to insurance cover is not available in later years of the contract.

Paragraph 25 requires that the "new" contract is recognised at the earliest of:

(i) the beginning of coverage period;

(ii) the date of the first payment; and

(iii) the moment that the contract becomes onerous.

So, for a non-onerous contract, a new right or obligation could occur before the first related payment, and when treated as a new contract, the rights or obligation should then already be considered before the payment date.

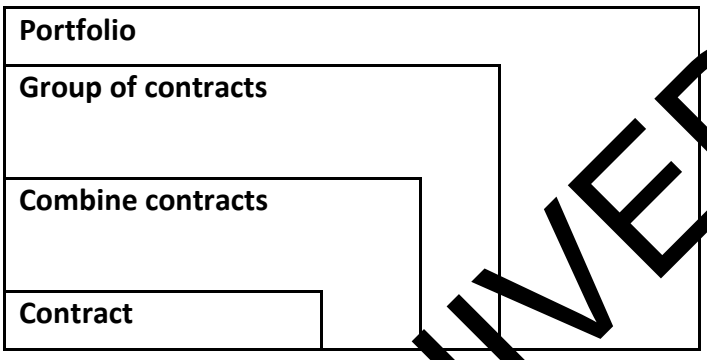
1.18. When should a contract boundary be reassessed?

Paragraph 64 states that the boundary of a contract should be reassessed at the end of each reporting period, in order to include the effect of changes in the substantive rights and obligations of the entity.

It might be argued, in our example of future premiums being outside the current boundary of a contract, that any new premium paid could be seen as "crossing" the existing boundary and extending the new boundary by including the newly received premium and all related cash flows.

Aggregated levels of insurance contracts

IFRS 17 defines different levels at which insurance contracts can or should be aggregated.



In this section we discuss each of these levels.

1.19. When should contracts be combined for measurement purposes?

Paragraph 9 states that contracts may need to be combined and treated as a whole, in order to report their substance, if they have the same or related counterparty and as a set achieve, or are designed to achieve, an overall commercial effect. Paragraph 9 gives the example of two contracts that negate each other. This was discussed at the May 18 TRG, see paper AP01 and the TRG observed that:

- A single legal contract would generally be considered on its own to be single contract in substance, but there may be circumstances when a set of contracts are in substance one contract;
- Determining this requires careful judgment and consideration of all the relevant facts and circumstances, and no single factor is determinative in making this assessment;
- Considerations that might be relevant include:
    - Rights and obligations are different when looked at together compared to individually. For example, rights and obligations in one contract may negate those in another;
    - One contract cannot be measured without considering the other, e.g., the contracts are highly interrelated;

- An existence of a discount, of itself, does not mean that a set of contracts are designed to achieve an overall commercial effect.

If the assessment leads to the conclusion that paragraph 9 applies, then the contracts as a whole need to be combined.

1.20. What is the meaning of "portfolio of insurance contracts" in IFRS 17?

A portfolio comprises contracts subject to similar risks and managed together. Paragraph 14 also notes that contracts within a "product line" would be expected to have similar risks and hence be in the same portfolio if they are managed together.

1.21. What does it mean that "contracts have similar risks"?

In general, IFRS 17 and its Basis for Conclusions contain several sections related to this question. The relevant wording in paragraph 14 is as follows:

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. If contracts cover similar risks and are within the same product line, they are subject to similar risks.

"Similar" does not mean "identical". Some variation in risk is reasonable, as long as the contracts are sufficiently similar. Since insurance is diverse and all portfolios are different, no prescriptive guidance can be provided on the correct level of materiality for the definition "of similar" and the decision process is likely to be entity specific.

Note that IFRS 17 discusses similar risks, which may not necessarily have the same interpretation as "similar insurance risks". Therefore, an entity may consider other risks such as lapse and expense risk in their determination of what similar risks means.

1.22. What does "managed together" mean?

Again, there is no clear definition in IFRS 17 for this term. Hence judgment is required on what constitutes managed together.

From a practical perspective, the considerations relating to subject to similar risks noted above will require a level of granularity in assignment of portfolios that, in many cases, could result in portfolios that are naturally managed together.

It is expected that the determination of the portfolio level will vary between entities, due to different sizes and complexity, as well as the different ways in which business is managed. A practical approach to determining the portfolios for an entity might rely on the internal management reporting systems. For example, an entity's internal management systems may consolidate results into product lines. These product lines could provide a suitable aggregation of similar risks; furthermore, an entity may have its systems aligned with its internal management structure and may disclose to the market

on that basis. This might constitute a suitable aggregation basis for what is considered as 'managed together'.

Other factors to consider against the test of managed together could, amongst others, include:

- distribution channel(s) that the contracts are sold through;
- the level at which regulation takes place, for example compulsory third party insurance in Australia;
- capital allocation basis; and
- the operating model or management structure of the entity, including how management incentives are structured.

Product line groupings as prescribed by prudential regulators may not necessarily be appropriate to define portfolios due to a different focus in IFRS 17. The latter's primary focus is about reporting appropriate profits and losses (BC114) rather than solvency focus of prudential regulators.

Note that an entity may change how it manages its business over time. As a result, the number of portfolios may change over time. This is an anticipated response under IFRS 17, although it does not necessarily affect the number of groups as historical groups do not change and groups are a sub-set of the portfolios.

1.23. What are the potential impacts of an entity's choice of portfolio?

The definition of portfolio has an impact on:

- further grouping of contracts, which can only be done within a portfolio;
- the level at which entities can make an accounting policy choice determination to reflect all insurance finance income or expenses in profit or loss, or disaggregate it between profit or loss and other comprehensive income. This comes from the fact that the IASB assumes that each portfolio has its own portfolio of assets backing the insurance contracts (see BC42 to 44).
    - Expenses included in measurement as they need to be directly attributable at portfolio level (see paragraphs B65(e) and B66(d).

It is important to remember, however, that the significance of insurance risk should not be considered at portfolio level, but still in relation to individual contracts (see paragraphs B22 and BC79).

Groups of contracts

1.24. What are the requirements for contracts in the same portfolio to be grouped together in a group of insurance contracts?

Please see chapter 5 where this is discussed.

1.25. What if cash flows are measured at a higher level than the group of contracts or portfolio?

Please see chapter 2 where this is discussed.

Section A – Introduction to the General Measurement Approach

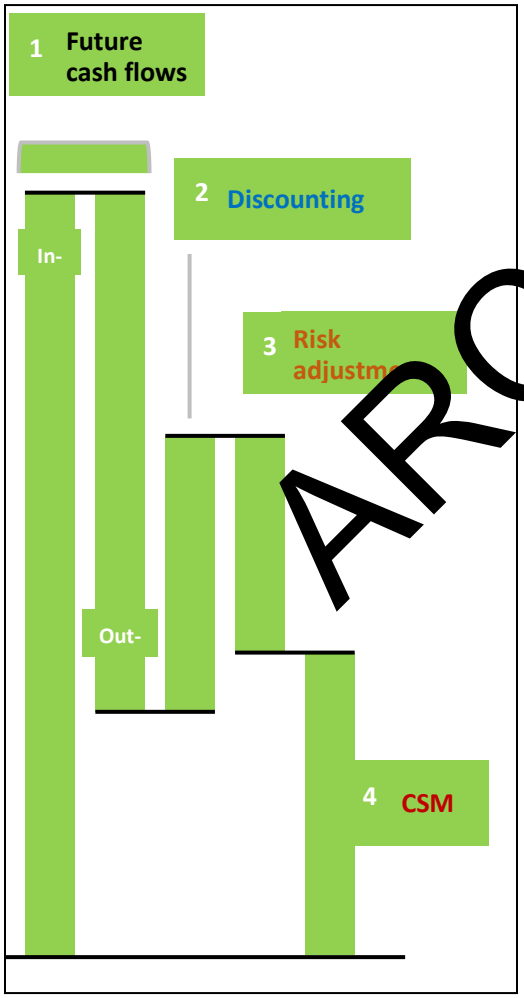
This section includes five chapters that cover the technical aspects of the general measurement approach (GMA).

These areas are:

- Estimates of future cash flows (chapter 2);
- Discount rates (chapter 3);
- Risk adjustment (chapter 4);
- Contractual service margin (chapter 6).

There is an additional explanatory section on levels of aggregation of contracts for the use of the GMA (chapter 5).

When considered together these are often referred to as the "building block approach" as shown below:



1 Unbiased estimate of future cash flows

The estimates of cash flows used to determine the cash inflows and outflows relevant to the fulfilment of the insurance contract. These estimates should be explicit, unbiased and probability-weighted.

2 Discounted to balance date

A "risk free" plus illiquidity adjustment for most contracts, the discount rate reflects the characteristics of the insurance liability and is consistent with relevant observable market inputs for each reporting period.

3 Add risk adjustment

An adjustment to reflect uncertainty in future cash flows relating to non-financial risk.

4 Allow for profit/loss effect

CSM eliminates the recognition of any future accounting profit at inception. CSM cannot be negative (i.e., the present value of any onerous contract must be charged immediately to losses). CSM is spread over the remaining coverage period.

What are the building blocks that make up the general measurement approach?

Paragraphs 29-52 provide guidance on this topic. BC 18-26 and BC 36-119 also provide background on the GMA.

The IAA has published a paper on current estimates (Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins) – see, in particular, chapter 2, and monographs on discount rates (see chapter 3) and on stochastic methods that may be useful for this purpose. More recently, a monograph on risk adjustment was released in May 2018 (see chapter 4). In general, we do not repeat material from any of the monographs in this IAN. In addition, the general educational material of IAA members provides significant educational material on the different ways to estimate future cash flows. All of this educational material may be relevant.

The following paragraphs provide educational material on the use of the various "building blocks"[7] that make up the GMA in measuring a group of insurance contracts on initial recognition, and subsequent measurement. There then follow five chapters providing more in-depth educational material on individual aspects of the measurement model in greater detail.

Given the principle-based nature of IFRS 17, there is potential for differing interpretations of the various building blocks. Consequently, it is possible that comparison between reporting entities may reveal inconsistencies. Further, definition of the various building blocks may include either "overlapping" (or double-counting) of various aspects of the building blocks, or "gaps" (or omissions of certain elements). The scope of the actuary's assignment may include responsibility to ensure that the building blocks are appropriately constructed, and that no such overlaps or gaps occur. Some examples of potential situations for differing interpretations follow:

a) In defining the ***"estimates of future cash flows"***, IFRS 17 refers to "the expected value (i.e., the probability-weighted mean) of the full range of possible outcomes" (paragraph 33). However, in the Basis for Conclusions for IFRS 17, the reporting entity is led towards use of "all reasonable and supportable information available without undue cost or effort about the future cash flows" (BC 18).

   In practice, therefore, judgment will be needed, particularly in the incorporation of the extremes of the potential distribution of outcomes. For instance, estimates of certain extreme outcomes may not be supportable, and may need to be included by way of a subjective adjustment. Even if it is judged that such an adjustment would not be material to the expected value of the future cash flows, the impact on the risk adjustment may still be material.

b) In defining an adjustment for the ***"time value of money"***, IFRS 17 incorporates the need to allow for "the financial risks associated with the future cash flows" (BC 19), hence arriving at a risk-adjusted rate of discount. However, it also recognises that certain

insurance contracts may combine financial and non-financial risks in such a way that "those components are interrelated" (BC 18). Hence, there is potential for the adjustment for the time value of money to exclude financial risk adjustment.

Judgment is needed in setting the barriers between the risks to be included in the discount rate.

c) In defining the ***"risk adjustment for non-financial risk"***, IFRS 17 does not separately define non-financial risk and effectively defines it by reference to "***financial risk***", the definition of which leaves room for judgment (see chapter 4 for background).

Again, this leaves room for judgement in setting the barrier between financial and non-financial risk.

d) The illiquidity risk may be included in the discount rate, or alternatively it can be allowed for as part of the risk margin (see chapter 3 for background).

The risk culture of the entity may inform the constitution of the building blocks, including:

- The perceived boundary between reasonable and unreasonable (i.e., spurious) cash flow projection in relation to the insurance contracts;
- The pricing bases for insurance products;
- Treatment of any asset and liability mismatch allowance/reserve, since this can be represented in different ways; and
- The cash flows and risks within the boundary of the contract under IFRS 17 and those used for other purposes.

Chapter 2 – Estimates of Future Cash Flows

Before consulting this chapter, be sure to read the Introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

2.A. What does this chapter address?

This chapter provides information concerning the estimates of future cash flows for use in measurement of liabilities and assets arising under contracts within the scope of International Financial Reporting Standard (IFRS) 17 *Insurance Contracts*. This applies both at issue of the contract and at subsequent measurements.

2.B. Which sections of IFRS 17 address this topic?

Paragraphs 33-35 and B36-B71 provide guidance on this topic.

BC 146-184 also provide background on the subject.

2.C. What other IAA documents are relevant to this topic?

The IAA has published monographs on current estimates (Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins) and on stochastic methods (Stochastic Modeling) that could be useful for this purpose. In general, we will not repeat material from either of these monographs in this chapter.

In addition, the general educational material of IAA members provides significant educational material on how to estimate future cash flows. All of this educational material could be relevant.

General Issues:

2.1. What are the requirements of IFRS 17 regarding the measurement of estimates of future cash flows?

Paragraph 33 includes the key characteristics of the measurement of estimates of future cash flows, namely they:

i. Include all future cash flows within the contract boundary;

ii. Are the probability weighted mean of the full range of possible outcomes;

iii. Are unbiased (i.e., they do not include the risk adjustment for non-financial risk);

iv. Reflect the perspective of the entity (except that estimates of market variables are consistent with observable market variables for those variables);

v. Are current; and

vi. Are explicit.

In estimating future cash flows, the actuary may need to adjust the results to reflect the specifics of the entity for which the cash flows are being estimated. For example, different entities may have different underwriting or claim settlement practices that might affect the estimated future cash flows. While past experience may reflect the practices in effect

at the time, if the entity has made changes to those practices, past experience may need to be adjusted for the changes.

2.2. What are the common types of cash flows to be included?

Cash flows referred to in IFRS 17 are primarily payments of cash exchanged between the parties under an insurance contract in accordance with the terms and conditions of the contract. The term "cash flow" can also be used as shorthand for other transfers of economic resources (cash flow equivalents) that are not settled in cash between the parties to the insurance contract. They may also include such items as administration costs, certain overheads (per B65), payments to third parties and non-cash transactions such as the provision of goods and services.

Some non-cash transactions may be subject to other IFRSs that determine the amount of transfer of resource caused by fulfilling the contracts in the respective period. Measurement of future cash flows accordingly includes the allocation or transfer of resources to those future periods under the applicable IFRS.

Future cash flows may refer to any component of the insurance contract that is covered by IFRS 17 excluding separated components. Cash flows do include components that might sometimes be seen as separate but are not separate under IFRS 17 (e.g., policy riders or policy loans). See chapter 1 Classification for additional discussion of this topic.

Paragraph B65 states:

"*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.*"

(See chapter 1 Classification for more on contract boundaries).

These cash flows include, but are not limited to:

- Premiums;
- Payments to (or on behalf of) policyholders including
    - claims that have been reported but not yet paid;
    - Payments that depend on the performance of underlying assets;
    - Payments from embedded derivatives; and
    - Incurred claims that have not yet been reported.
- Payments on future claims on unexpired risks;
- An allocation of insurance acquisition costs;
- Claim handling costs;
- Costs the entity will incur for payments in kind;
- Policy administration and maintenance costs;

- Transaction-based costs such as premium taxes and levies;
- Taxes paid in a fiducial capacity to meet obligations of the policyholder;
- Potential cash inflows from recoveries; and
- An allocation of fixed and variable overheads directly attributable to fulfilling insurance contracts.

Sometimes, it might be permissible (e.g., due to immateriality) to also consider cash flows exchanged between the parties under the contract not based on the actual payment date but based on a due date or the date when the triggering event incurs.

2.3. At what level are cash flows determined?

Cash flows are generally identified at the individual contract level if possible (e.g., not for claims not reported). For measurement purposes, however, contracts are aggregated into portfolios and groups of contracts (chapter 5 on unit of account for more on this). IFRS 17 allows, moreover, the entity to estimate the cash flows at whatever level of aggregation is most appropriate from a practical perspective. If the entity makes estimates at a higher level, it needs to be able to allocate those estimates to groups of insurance contracts so that the appropriate amounts are included in the measurement of the groups of insurance contracts' fulfillment cash flows for remaining coverage and incurred claims.

Assumptions may be derived at aggregation levels that are different from the aggregation level applied for measuring contracts. In that case, judgement will be needed to determine what adjustment, if any, is needed to apply them at the required aggregation level. For example, maintenance expenses may be determined for all life insurance contracts, but separate assumptions may be needed for term insurance and whole life contracts.

In some cases, particularly for general insurance contracts covering multiple risks and/or perils, it may be helpful to analyse the experience separately for each of those multiple coverages. Such separation for analysis and projection purposes, is particularly appropriate when the balance of coverages varies from contract to contract within a line of business, such as small business package policies. Such coverage cash flows may then be combined at the contract level (if practical and useful) before contract cash flows are aggregated into groups and portfolios for measurement purposes. Similar concerns will also apply to life insurance contracts with multiple risks (e.g., mortality and disability) or groups of insurance contracts with multiple durations (e.g., 10, 20 and 30-year term in the same group of insurance contracts).

In summary, BC117 states: "IFRS 17 allows an entity to estimate the fulfilment cash flows at whatever level of aggregation is most appropriate from a practical perspective. All that is necessary is that the entity is able to allocate such estimates to groups of insurance contracts so that the resulting fulfilment cash flows of the group comply with requirements of IFRS 17." Paragraph 24 gives effect to this.

Issues concerning the definition of cash flows to be included

2.4. What is a current estimate?

A current estimate at the report date is the entity's estimate based on currently available information in a manner consistent with relevant accounting guidance. The term "current estimate" is used in this chapter as a short form for the "current unbiased estimate of the future cash flows".

IFRS 17 defines the term "fulfilment cash flows" as including the risk adjustment for non-financial risk (herein shortened to "risk adjustment") and the effect of discounting. This chapter, however, does not refer to issues regarding calculating present values but focuses on the identification of cash flows and estimating unbiased expected values of those cash flows.

2.5. What is the meaning of expected value?

For IFRS purposes, "expected value of cash flows" represents the mean of the (typically unknown) probability distribution of cash flows. In line with this mathematical concept, IFRS 17 requires that conceptually all scenarios are covered in determining the value of the cash flows, including scenarios in the extreme tails of the distribution. Where the variability in future cash flows follows a symmetric distribution, actuaries may conclude that the impact and likelihood of favourable and unfavourable extreme scenarios not explicitly considered in a model may broadly offset each other; however, where the distribution of future cash flows is skewed it may be necessary to adjust the expected value to reflect extreme scenarios not allowed for in the model.

For example, the probability distributions of general insurance property claims tend to be positively skewed. The available data for similar products may not be sufficient to fully reflect the future impact of abnormally large claims. In these situations, it is often necessary to rely on other sources of data and judgment to adjust the models. This tends to increase the expected value to reflect these high-cost but low frequency events. Similarly, actuaries may consider it appropriate to take into account favourable extreme scenarios such as, for life insurance, a fall in mortality rates if an affordable cure for cancer is developed. All such adjustments would require judgment on the likely impact and probability of occurrence to adjust the modelled expected value.

The reference in IFRS 17 to scenarios is about the defining characteristic of the mean value of a distribution function rather than providing guidance regarding how to estimate the mean value. It does not require that all possible (or even any) scenarios be explicitly constructed nor is it expected that entities will develop stochastic models for all IFRS 17 reporting.

2.6. Does the distribution function of cash flows need to be determined?

Not necessarily. The accounting purpose is to derive a current unbiased estimate of the expected value of cash flows. There are a variety of approaches that can be used for this purpose and IFRS 17 does not provide any guidance regarding how the estimate is to be made. Any statistical or non-statistical approach applied in determining figures for an IFRS

report needs to comply with general accounting requirements as outlined elsewhere in this chapter.

2.7. What does "unbiased" mean?

According to BC 148ff, unbiased estimates:

a) Capture information about the full range of possible outcomes,

b) Should not have an intention of attaining a particular outcome, or

c) Influencing a particular behavior.

Therefore, an unbiased estimate does not include either conservatism or optimism.

2.8. How does the object for current estimates as intended by IFRS 17 differ from objectives used for other purposes?

IFRS 17 calls for an estimate of the statistical mean, rather than the statistical median or mode. Other descriptions, such as best estimate or best estimate plus a margin, used in other accounting structures, may not be the same. Before using cash flows developed for other purposes, their fitness for reporting under IFRS 17 may need to be assessed.

2.9. How are cash flows that do not directly belong to the contract, but are contractual, distinguished from cash flows belonging to the entity in general?

Cash flows belonging to the contract are those that are specifically generated because the contract is in existence (e.g., benefits, commissions, direct administrative expense). Indirect administrative expense, including general overheads, are included only if they are directly attributable to fulfilling a portfolio of insurance contracts as per paragraphs B65(l) and B66(d). If they are not, they are general expenses of the entity not belonging to the contract and are thus not considered in estimates of future cash flows of the contracts.

IFRS 17 is silent with respect to techniques to be used for estimating cash flows, therefore no special techniques are required to determine these indirect expenses included in future cash flows. Methods used for pricing or other types of reporting might be usable for this purpose so long as the result meets the requirements of IFRS 17.

Any cash flows or costs of the entity related to other standards are not discussed in this chapter. When investment administration expenses are estimated, only expenses that are required by the contract are included, not the expenses of the actual investments of the entity. Under normal circumstances, investment expenses are not included in the estimate of future cash flows. An exception to this may apply when those investment expenses are required by the insurance contract.

2.10. To what extent do the estimates of future cash flows have to differentiate contracts with different characteristics (e.g., age, gender), and other known differences of contracts?

Statistical estimates are usually only differentiated for a limited number of characteristics of the item to be estimated and include the average effect of other characteristics. IFRS 17 does not require the entity to assess all characteristics of a contract that might be relevant to the outcome and establish estimates on that basis. Paragraph B37 does require consideration of "all reasonable and supportable information available at the reporting date without undue cost or effort."

Accordingly, it is a matter of judgment as to what degree characteristics of individual contracts are considered in estimating future cash flows. It may be appropriate for individual contracts to be aggregated into groups of contracts that are not further distinguished. B37 does note, however, that "information available from an entity's own information systems is considered to be available without undue cost or effort."

Paragraph 17 may require identification of the fulfilment cash flows of an individual contract, for the purposes of initial grouping. Accordingly, assumptions that are appropriate for that purpose would need to be chosen for each contract. It is necessary to determine the degree to which the assumptions are differentiated for the characteristics of individual contracts. The individual characteristics of each contract are only considered to the extent that the assumptions are differentiated on the basis of those characteristics.

The actuary may consider a wide range of factors in an internal experience analysis used for determining liabilities for remaining coverage and incurred claims. This consideration is to determine whether it is appropriate to incorporate those factors explicitly into the analysis and whether it is appropriate to then incorporate them into the measurement. Factors need not be incorporated in the analysis unless there is reason to suppose that they can reasonably be collected and used by the insurer without undue cost and that they are likely to materially impact the measurement of the fulfilment cash flows of the groups of insurance contracts.

Many characteristics of contracts will not be available to the entity in any case. For other characteristics, even if known, the entity might not be able to assess their impact due to limited statistical data or the undue cost or effort to obtain them. Other characteristics of contracts will not be consistently available for all contracts and, as a consequence, may be ignored since they can only be averaged over other contracts. Other characteristics, which might be assessable at outset or are even assessed, might be ignored in pricing since the overall benefits from such a differentiation would not outweigh the cost of doing so. For example, certain medical examinations or adjusting information systems to differentiate a certain characteristic could be more expensive than the price effect. An entity might thus limit the differentiation of contract characteristics to a certain number that can reasonably be administratively and statistically managed.

Accordingly, for estimating the liability for remaining coverage, the differentiation of assumptions as applied to individual contracts might start with the differentiation used

for pricing. Less differentiation than applied in pricing might, if applied to individual contracts, result in inconsistencies between premiums and the measurement of the related cash outflows, if the cash flows are based on averaged assumptions while the associated premiums are more differentiated. For example, a contract viewed in pricing as being riskier and accordingly having a higher premium, would be compared with an average risk and therefore would show a high CSM (unless offset by a higher risk adjustment) while a contract seen in pricing as less risky and accordingly having a lower premium would result in comparison with the average risk, resulting in a low CSM or even showing a contract as onerous.

There are exceptions to this principle. Paragraph BC135 (a) refers to an "intentional pricing strategy". If the entity underprices certain contracts intentionally, e.g., to gain market share, by ignoring certain relevant and known characteristics of the contracts, it might have the same consequences as if the entity chooses to charge insufficient premiums. Accordingly, measurement considers those peculiarities of the respective contracts and differentiates assumptions on that basis. As a consequence, the premiums agreed for that contract might turn out to be insufficient to cover the value of the risk.

Furthermore, paragraph 20 allows an exception for grouping, where law or regulation constrains the use of specific characteristics for pricing (e.g., where pricing of annuities must be on a unisex or gender-neutral basis). In such cases, the insurer may include such contracts in the same group, but only if they would otherwise fall into a different group due solely to the regulatory pricing constraints. Note that this does not allow those specific characteristics to be ignored in the measurement process, only for grouping.

It is acceptable to allow for the average impact of considered characteristics for the contracts in a group, so that only the average impact of the characteristics is reflected in the measurement, provided that it reflects the true mix of such characteristics in the group. If the composition of a group changes, however, it may be necessary to reassess the average impact, so that it continues to reflect the mix of characteristics in the group.

Inflows

2.11. What are the cash inflows to be considered?

All cash inflows arising under rights of the insurance contracts and relating to services provided within the contract boundary are considered. The primary inflow is, of course, premium. Investment income, other than that related to policy loans (see below), is not included since it is a cash inflow due to investments and not specifically related to the fulfilment of the contracts.

Other cash inflows considered include such items as salvage, subrogation, contract charges such as cost of insurance charges, and claw-backs of agent commissions originally paid related to the contract. The treatment of such recoveries is not specified in IFRS 17. Any actuarial estimates of such recoveries need to be consistent with their accounting treatment to avoid double counting or omission of these cash flows.

Cash inflows on insurance riders and future insurance options, such as disability premium waiver, hospitalisation, term insurance, guaranteed future insurance (including cash flows from the expected exercise of such guarantees) will also be included if they are related to services provided within the contract boundary. See chapter 1 for more on contract boundaries.

2.12. How are policy loans and repayments handled?

If policy loans are a component of the insurance contract (i.e., terms are guaranteed in the contract), loans and repayments of policy loans are part of fulfillment cash flows. If future policy loans are initiated within the contract boundary, expected future loans and repayments as well as interest accrued on outstanding loans are also a part of the fulfillment cash flows.

2.13. How are premiums prepaid with interest accretion treated?

Prepaid premiums are treated the same as premiums paid at their due date. They are part of the cash inflows and the frequency and effect of their occurrence is included as part of future cash flows. In some cases, there is an agreement that the insurer grants a rebate on prepaid premiums in the form of interest accreted. If this agreement is a component of the insurance contract and not separated as a distinct investment component, the rebate is considered in measurement and treated as an adjustment to premium as per paragraph B65(a).

IFRS 17 does not directly address the issue of recognition of prepaid premiums but does require that liabilities reflect paid premiums not premiums due. In the same way as insurance acquisition cash flows arising before recognising the group of insurance contracts are an asset according to paragraph 27, liabilities arising from prepaid premiums might be recognised but not necessarily as part of the cash flows.

2.14. How are extra premiums paid for substandard risks included?

Extra premiums for substandard risks are treated identically to other premiums. It is, moreover, important that expectations for the related future benefits are estimated on the basis of the correspondingly higher risk, so as to be consistent with the extra premiums. Actuaries might also consider whether the statistical knowledge available about the higher risk provides an adequate basis from which to develop an appropriate estimate that deviates from the extra premium determined. Similar considerations apply for premium rebates for risks better than standard.

Outflows

2.15. What are examples of outflows included in future cash flows?

Benefit payments, directly related expenses and similar items are the important items included in cash outflows.

2.16. What kind of data is used to estimate future cash outflows?

Paragraph B41 requires assumptions to be based on information including, importantly, the entity's own experience to the extent it is available, supportable and credible. The

results arising from this data may be adjusted if there is reason to believe that historical trends will not continue in the future or if other influences may affect them. If internal data is not available, either in whole or in part, then industry or other available data, e.g., population data, may be used as a basis for the assumptions. In general, an entity's experience will be analysed for this purpose using an internal experience study.

Paragraph 33 (a) and B37 set limits on the effort required to collect the statistical basis of determining the assumptions. In general, information used should be reasonable, supportable and obtainable without undue cost or effort. Information available from the insurer's own information system, e.g., internal experience studies, and other sources used for pricing is considered available without undue cost or effort.

2.17. How are available inputs from financial markets and from other external sources applied to cash flow estimates?

If, for example, a portfolio has new elements on which the entity has no or limited experience, external inputs, such as industry experience, might be used. Available inputs from financial markets and from other external sources may not, however, represent characteristics of the cash flows of a certain portfolio; if that is the case, the entity's estimate or an adjustment to financial market information may be needed. As the entity obtains sufficiently robust experience of its own, it may consider supplementing the external data with it or eventually substituting its own experience.

2.18. What methods are appropriate to estimate future cash flows that might be dependent on market variables?

Stochastic projections (see IAA monograph on stochastic modeling) are allowed but are not necessarily required. They are, though, more likely to be needed for skewed risks than risks with symmetrical distributions. Stochastic methods will more likely be used to develop estimates of a risk adjustment (see *IAA Monograph: Risk Adjustments under IFRS 17*) or interest rate dependent cash flows than the usual mean estimate of common benefits. IFRS 13 refers to using, but does not require, stochastic modelling regarding cash flows that are asset-return sensitive (paragraph B48) and also if cash flows reflect a series of interrelated options (see paragraph B39 and paragraph B28 of IFRS 13 about the extent of such modelling needed).

In most cases, interest assumptions for stochastic models will be "risk-neutral" rather than "real world".

2.19. What needs to be considered in estimating policyholder behaviour (e.g., surrender rights, options to convert to other types of contracts if such an option exists in a contract e.g., between a term and whole life contract)?

The basis for the expected value is the entity's estimate of future expected behavior (based on experience and judgement), not necessarily rational financial behaviour (see B62). Experience might cover only a very limited range of circumstances as incurred up to the present. Accordingly, for a wide variety of possible future circumstances, no past experience may be available. In filling that gap, the actuary may wish to consider whether

the chosen assumptions have a significant effect on the outcome compared with the outcome resulting from assuming that the behavior would be in line with past experience even in changed circumstances. If the difference is relevant, the actuary may consider if and how the experience needs to be adjusted to reflect expected future conditions (paragraph B41(c)). Risks from such assumptions are to be considered in the risk adjustment to the extent they are non-financial risk, depending on the nature of the risk. The expected value considers both advantageous and disadvantageous behavior of policyholders.

One of the considerations when setting assumptions is the possible effects of policyholder anti-selection. In certain circumstances policyholder behavior will depend on financial assumptions. In such situations, it may be important that those policyholder behavior assumptions be consistent with the interest rate assumptions being used. This may be true whether or not a stochastic approach is used.

Internal Costs

2.20. What methods are appropriate to estimate expected future internally incurred costs?

Estimates of future management costs will usually make use of any forecasts the entity makes including budgets and business plans. Those future unit costs will usually anticipate inflation. It is also appropriate to allow for expected future economies (or diseconomies) of scale, consistent with the likelihood of these scenarios and unbiased mean.

Future unit costs will also consider the likelihood of the entity being measured as a going concern. Unit costs may therefore need to reflect a reasonable development of future new business, if appropriate, in deriving an unbiased estimate of the mean.

2.21. How are administration costs that are paid or expected to be paid prior or subsequent to contractual due date handled?

The proper measurement is based on the expected actual payment date, not the due date, and allows for any consequences of early or late payment (e.g. pre-paid or annualised commissions, interest accreted, penalties charged). If it can be shown, however, that there is no material difference between the actual and due dates, the measurement could be based on due dates. Caution needs to be taken to ensure consistency with the accounting treatment, to avoid double counting or omission.

2.22. Which cash flows other than claims payments and contractual services may be considered?

The key guidance for differentiating cash flows other than claims payments and other contractual services is the exclusion of general overhead costs in paragraph B66 (d) if they "cannot be directly attributed to the portfolio of insurance contracts that contain the contract". See B65(i), on the other hand, for examples of some overheads that are included in estimated future cash flows. Those general overhead costs are not included in the estimate of future cash flows of IFRS 17 and are accordingly subject to authoritative

guidance in other IFRSs determining their recognition, measurement, presentation and disclosures. This chapter does not discuss such items.

The reference to "directly attributable" is a generally used phrase in IFRS and the entity might have previously adopted interpretations of that term in its accounting policies. This chapter does not discuss further the accounting meaning of this phrase. The accounting interpretation of this phrase might, however, result in the need to choose the partition of the business into portfolios of insurance contracts (PIC) suitably to allow an adequate split of currently incurred and future expected cost between those "directly attributable" to a PIC and general overhead that is not considered in measurement and presentation of insurance contracts.

After identifying those internal costs that can be directly attributed to portfolios of insurance contracts, those costs might be differentiated regarding their function in fulfilling the insurance contracts. IFRS 17 distinguishes insurance acquisition cash flows from other internal costs. IFRS 17 is silent regarding how to accomplish this separation, which might be seen as an indication that normal cost accounting approaches, particularly key allocations between functions are appropriate.

In summary, the identification of costs considered in measurement might be split in three separate steps:

1) Exclude costs that are not directly attributable to a portfolio of insurance contracts (B66 d)).

2) Allocate the remaining costs to function, i.e., insurance acquisition cash flows, servicing contracts during their coverage period and settling claims based on normal cost accounting principles (B65 e), (f), (h) and (l)).

3) Allocate the identified costs per function to each group of insurance contracts "using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics" (B65 (l).

2.23. What are insurance acquisition cash flows?

Insurance acquisition cash flows are defined (see appendix A of IFRS 17) as "*the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or group of insurance contracts within the portfolio."* These include direct payments, such as commissions, underwriting costs, and other costs of contract issue specific to a particular contract, but also include such costs incurred for a portfolio of contracts. They may not include allocation of some overhead expenses.

To differentiate acquisition costs from other costs, particularly contract administration costs, the contract boundary might be of relevance. If a payment is contingent on persistency beyond the contract boundary, it might be seen as an acquisition cost outside the contract boundary. Therefore, those costs are not included in the cash flows of the existing contract. In that case, the item is recognised as an expense only when the new

contract becomes in force. If the payment is contingent only on persistency within the contract boundary it is generally an administration cost.

2.24. How are insurance acquisition cash flows considered if paid prior to initial recognition of the related group of insurance contracts?

Insurance acquisition cash flows incurred prior to initial recognition are reflected as paid and capitalised until the related group of insurance contracts is issued. An exception to this is for contracts using the PAA that have a duration of 12 months or less. Such contracts may choose to recognise acquisition costs as expenses when incurred (paragraph 59).

2.25. How are insurance acquisition cash flows considered if paid in a reporting period (in the same year, in a subsequent year) after initial measurement (e.g., renewal commissions or asset-based commissions)?

Insurance acquisition cash flows incurred after the initial sale, are reflected in the same way as other future costs, regardless of the year in which they are paid. That is, they are included in the contract's estimated future cash flows on a probabilistic basis. Therefore, for example, if the payment of the commission is dependent on the policy continuing within the contract boundary, the probability of lapsation is reflected.

In this sense, they are considered to be directly attributable expenses. The question of whether they are acquisition costs or direct administration costs is moot.

2.26. If agent / agency compensation is contingent upon agent/agency survival, how might those expenses be reflected (and if so, how might agent/agency turnover be considered)?

These expenses are usually included in estimated future cash flows in the same way as for other contingent cash flows, e.g., claim handling costs. Hence if agent/agency turnover materially affects expected cash flows, this needs to be considered in determining estimated future cash flows whether the expenses are for acquisition or maintenance of the contract.

2.27. What are some examples of expenses that are or are not insurance acquisition cash flows?

Insurance acquisition cash flows include, but are not limited to:

- Commissions to sales personnel;
- Payments to managers of agencies or brokerages based on a percentage of commissions or other measurements of sales;
- Underwriting costs; and
- Contract set up expenses.

The following might not be considered insurance acquisition cash flows:

- Payments to managers of agencies or brokerages not based directly on sales;

- Payments to managers of agencies or brokerages based on policy persistency; and
- Premium and commission processing costs.

Other Cash Flow Issues

2.28. Are any taxes included in cash flows?

See B65. All 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) are included in cash flows. Wage based taxes, referred to as payroll taxes, social security taxes and similar items, are also included to the extent the wages they are based on are included. Also included would be any taxes paid on behalf of the policyholder. If the impact of certain of these taxes is only the small difference of the time value of the incoming and outgoing cash flows, those impacts could usually be ignored based on materiality considerations but noted in disclosures.

Income taxes and other similar taxes (e.g., a tax based on investment income and expenses) levied on the entire entity are not included as a cash flow in contract measurement even if they are reflected in benefits paid to policyholders unless paid in a fiduciary capacity on behalf of the policyholder.

2.29. Are there any special considerations for discretionary or voluntary payments to policyholders?

For policyholder bonuses or dividends ,see chapter 8 on contracts with participating features and other variable features. Similar items on non-participating contracts (e.g., excess interest payments) will generally be measured in the same way they would be measured on a participating contracts. For other discretionary cash flows of the entity, including any fair dealing in determining claims payable, whether their consequences are within or beyond the contract boundary needs to be considered. If they are with respect to services provided within the contract boundary, they may also be measured at the expected value. Otherwise, they are generally not included.

2.30. How are policyholder dividends or bonuses projected for traditional participating contracts?

See chapter 8 on contracts with participating features and other variable features.

2.31. How are delayed benefits, benefits which are expected never to be paid, or events that create rights contingent on future events (e.g., annuities to persons under third party liability, or joint life) accounted for?

These benefits are normally included in the same way as other benefits, at their expected value. This may be different from previous accounting structures that, in some instances, measure such benefits only after they are elected.

2.32. How are interest credits paid to policyholders projected?

See chapter 8 covering contracts with participating features and other variable features.

2.33. Where is there available guidance for estimating inflation and its effects on inflation-sensitive benefits, claims and expenses?

Paragraph B128 (b) provides guidance on when inflation risk is to be seen as non-financial risk. When seen as financial risk, paragraph B51 provides as an example a reference to observed market interest rates. A range of statistics is available in different countries. General living cost or wage indices might be useful for many cash flows, but building, medical and other insurance relevant expenses may also have their own indices or may be responsive to specific factors other than general inflation. In addition, as inflation applies to the entity's internal expenses, the relative change in productivity and changes in the number of units can also influence trends in unit expenses. As long as observations can be made regarding (neutral) expected values of inflation in market prices for the specific cash flow to be measured, those observations have priority compared with the entity's expectations.

2.34. How can cash flows on blocks of business with no prior experience or no relevant experience (e.g., new line of business for entity, mortality past age 90 or coverage durations longer than the product has been issued) be estimated?

The best available relevant experience, both any related internal experience and any available data from the industry, may be considered. This is likely to be supplemented by documented judgment.

2.35. How might cash flows on contracts covering multiple perils be developed?

This depends on the nature of the contract and the nature of the peril.

For example, many general insurance contracts cover standard combinations of perils. In such cases, the standard combination might be treated as a single peril.

If the perils are fully independent, then simple addition can be used; however, if the data for one peril is not sufficient for a reliable estimate, then estimating cash flows by peril may not be recommended.

Interdependent perils (e.g., joint life, first death) can be adjusted for the probabilities of co-incidence.

2.36. How might cash flows on a single contract with multiple insured items, particularly if there is an open number of insured items in the contract (e.g., a group life contract or a corporate auto contract) be adjusted for added or deducted insured items?

Where an additional premium is to be agreed for each additional insured item (e.g., group life, health or disability), estimates may be made on the basis of the insured items active at the measurement date, since the additional insured item is beyond the contract boundary before it is added.

Where a fixed premium is charged even if the number of insured items can change within the contract boundary, then an expected value approach is appropriate for estimating the number of insured items which will be covered within the contract boundary.

Changes in estimates

2.37. How often are estimates re-evaluated?

Estimates must be re-evaluated at every reporting date. In compliance with paragraphs 33(c) and B54-B60, the assumptions for estimating the cash flows also have to be re-evaluated at each reporting date. If there is no positive indication that anything relevant has changed, however, no change to an assumption is allowed.

Chapter 3 – Discount Rates

Before consulting this chapter, be sure to read the Introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

3.A. What does this chapter address?

This chapter discusses practices related to interest rates, yield curves, discounting and replicating portfolios for insurance contracts as required by IFRS 17. First the general principles for discounting within IFRS 17 are discussed in questions 3.1-3.10. Discount rates used for cash flows that do not vary based on the returns on financial underlying items[8] are discussed in questions 3.11–3.24. Discount rates for cash flows that do vary based on the returns on financial underlying items are discussed in questions 3.25-3.31. Discounting related to PAA is covered in questions 3.32-3.35 and locked-in discount rates are discussed in questions 3.36-3.41.

3.B. Which sections of IFRS 17 address this topic?

Paragraphs 36 and B72 – B85 provide guidance on this topic.

Related sections are paragraphs B44-B48 (on market variables) and paragraphs 87, 110-113 and B128-B136 (on insurance finance income and expenses).

BC 19, BC 185 – BC 205, and BC 212 also provides background on the subject.

3.C. What other IAA documents are relevant to this topic?

The IAA has published a monograph on discount rates, "Discount Rates in Financial Reporting: A Practical Guide" October 2013.

General topics

3.1. What are the general principles related to discounting within IFRS 17?

An amount payable today has a different present value from that of the same amount payable in the future. In other words, money has a time value. Discount rates are used to adjust cash flows to reflect the time value of money. The following general principles underpin the discounting guidance within IFRS 17.

Principle 1: Estimates of future cash flows are adjusted for 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 (paragraph 36).

Principle 2: Discount rates are reflective of whether the cash flows vary based on the returns on any financial underlying items (paragraph B74).

- For some insurance contracts, e.g., most general insurance and non-participating traditional term life or non-participating whole life insurance, the cash flows are not

[8] The standard defines underlying items which might include both financial and non-financial elements. As only financial underlying items are relevant for the discount rate, only financial underlying items will be referred to in this section.

dependent on financial underlying items. IFRS 17 refers to these products as having **cash flows that <u>do not</u> vary based on the returns on any financial underlying items**. The discounting for these cash flows is discussed in questions 3.11-3.26;

- Other insurance contracts, e.g., unit-linked universal life insurance and variable annuities, typically have cash flows that are dependent on financial underlying items. IFRS 17 refers to these products as having **cash flows that vary based on the returns of any financial underlying items**. The discounting for these cash flows is discussed in questions 3.25-3.31;
- Based on the definitions in the standard, the distinction between cash flows that do vary based on the returns on financial underlying items and cash flows that do not vary based on financial underlying items is not equal to the distinction between insurance contracts with direct participation features and insurance contracts without direct participation features. This is further explained in question 3.9.

Principle 3: The discount rates applied to the estimates of the future cash flows reflect the characteristics of the cash flows and the liquidity characteristics of the insurance contracts (see paragraph 36a).

- The discount rates applicable to fully liquid instruments (the "risk-free curve") are discussed in question 3.12;
- The liquidity characteristics of insurance contracts are discussed in questions 3.14-3.17.

Principle 4: The discount rates are consistent with observable market prices, if any, for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts and they shall exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts (paragraphs 36b and 36c).

- The concept of a reference portfolio is discussed in question 3.12; and
- It may be possible to determine the discount rates for a portfolio of insurance contracts by identifying a replicating portfolio. This is discussed in question 3.29.

Principle 5: Assumptions for the estimates of discount rates are consistent with assumptions for other estimates used to measure insurance contracts to avoid double counting or omissions (paragraph B74). For example, if nominal cash flows include the effect of inflation they are discounted at rates that include the effect of inflation. Similarly, when discounting cash flows that vary with financial underlying items, the financial return assumptions used to estimate future cash flows and the discount rates used are aligned (see questions 3.25 and further).

3.2. For which purposes are discount rates required?

Paragraph B72 lists the purposes for which discount rates are required.

An entity shall use the following discount rates in applying IFRS 17:	
a) *to measure the fulfilment cash flows – current discount rates applying paragraph 36.*	Discussed in questions 3.11-3.31
b) *to determine the interest to accrete on the contractual service margin […] for insurance contracts without direct participation features – discount rates determined at the date of initial recognition […].*	Discussed in question 3.36
c) *to measure the changes to the contractual service margin […] for insurance contracts without direct participation features – discount rates […] determined on initial recognition.*	Discussed in question 3.37
d) for groups of contracts applying the premium allocation approach that have a significant financing component, to adjust the carrying amount of the liability for remaining coverage […] – discount rate […] determined on initial recognition.	Discussed in questions 3.33 and 3.34
e) If an entity chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income (IFRS 17.88), to determine the amount of the insurance finance income or expenses included in profit or loss:	
(i) for groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders […] – discount rates determined at the date of initial recognition […];	Discussed in question 3.38
(ii) for groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to policyholders […] – discount rates that allocate the remaining revised expected finance income or expense […] at a constant rate; and	Discussed in question 3.39
(iii) for groups of contracts applying the premium allocation approach […] – discount rates determined at the date of the incurred claim […].	Discussed in question 3.35

3.3. How are liquid risk-free rates determined in the context of IFRS 17?

A liquid risk-free yield curve is discussed in paragraphs B80 and in BC193. It is the basis of the bottom-up approach which is discussed in question 3.13. The liquid risk-free curve may not be required in a purely top-down approach (which is discussed in question 3.18).

IFRS 17 does not define a method to derive the liquid risk-free yield curve. Favourable characteristics for market quoted interest rates used in deriving a liquid risk-free yield curve might include those quoted interest rates:

- Being reliable and liquid;
- Containing no credit risk; and
- Having quoted/maturity dates for a wide range of terms/durations.

To set an entire curve, practitioners may, in some cases, consider using more than one security type or market index/reference rates to derive the overall curve. Thus, deriving the liquid risk-free curve may involve judgment.

Some options and considerations that might be applied are set out below[9]:

a. Government bond rates

Politically stable governments in economically developed countries are commonly believed to have a low probability of defaulting on their debts. This is because governments in such countries have taxing power and the ability to expand money supply (which is not the case for all governments). The rating of government bonds can be used as an indicator as to whether the bonds of the specific government may be considered risk free.

In the situation of a currency union, a basket of government bonds with a high rating might be used. In the situation of a currency union, an individual government does not have the ability to expand the money supply which may cause credit risk. Also, national governments can issue debt. If credit risk is present, an approach that estimates the credit risk component so that it might be removed is described in question 3.19 below.

Apart from the credit risk, the available maturities and the liquidity of the government debt market varies between governments. These may be factors when choosing between government bonds and alternative bases for the risk-free curve development.

b. Swap Curve

In many markets swap curves are observable and available for a range of terms. In some cases, they are more liquid and available for a greater range of terms than government securities.

Swaps are often used as instrument for replicating and hedging interest rate risk arising from derivative assets which makes them a natural reference to derive risk-free interest rates. Furthermore, swap contracts are typically collateralised and there is no risk on the principal value associated with the swap agreement, which substantially reduces the exposure to losses associated with a credit default event.

[9] Other publications on the subject could help the practitioner to derive such a curve (for example: (EIOPA, 2017), (IAA, 2013)).

For example, the EIOPA Solvency II approach[10] uses swap rates for currencies with deep financial markets.

Quoted swap rates may have to be adjusted in order to reflect:

- The counterparty credit risk: A party who is receiving a fixed interest rate (i.e., fixed/quoted leg) from another party is likely to require a premium on top of the interest rate to compensate for the risk related to future interest payments on the fixed leg in excess of the floating leg. The "swap rate" will include an allowance for credit risk and an adjustment would be required, taking into account collateralisation requirements.
- The underlying reference security credit risk: If swap rates are based on the yield of an underlying reference security with material credit risk premiums these risk premiums would need to be removed to obtain a risk-free rate.

Understanding the basis underlying quoted rates is important when choosing any adjustment in relation to counterparty risk. Similarly, understanding the underlying reference securities is important when choosing any adjustment for credit risk.

c. Corporate Bond Rates

Corporate bond rates are not risk free although in some jurisdictions, it may be the most widely traded market. Credit risks need to be considered in the context of corporate risks. Techniques that might be considered when using corporate bonds rates are similar to those presented in question 3.19.

3.4. How can risk free rates be determined if there is no well-developed bond or swap market?

When, for a given currency, there is no well-developed bond or swap market other approaches may be considered. Two situations can be distinguished:

a. The local currency is pegged to another currency; and

b. The local currency is not pegged to another currency.

The local currency is pegged to another currency

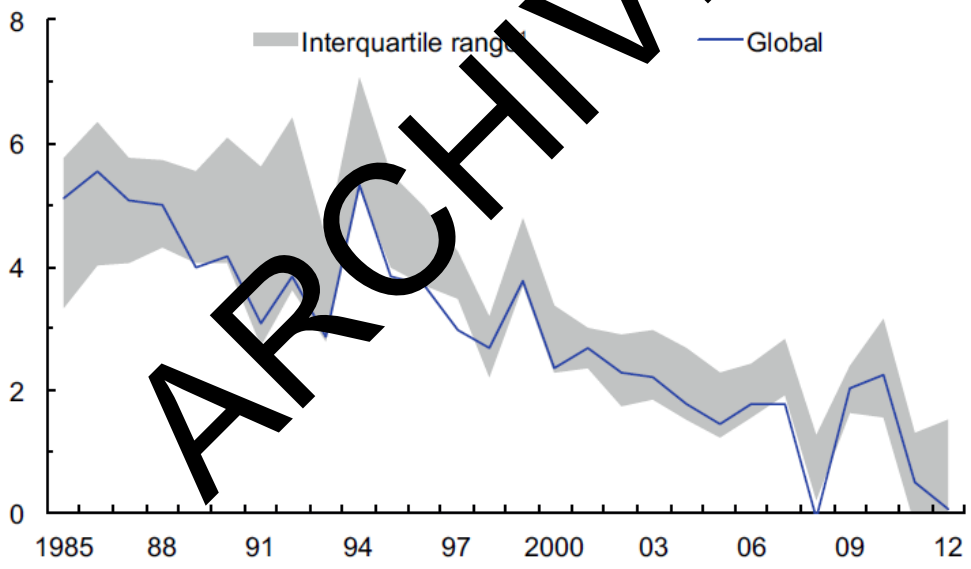
The suitability of this approach depends upon adequately allowing for any risks that the level of the peg may change. This risk causes a spread on rates in the local currency. Evaluating this risk may require particular care given that in these situations there may be a lack of forward exchange rate contracts which, if they were available, would be one source of a market observable measure of the risk of the peg changing. Observed deviations in the past from the pegging policy may be an indicator for a correction on the targeted difference.

[10] Note that the volatility adjustment is not compliant to IFRS 17.

The local currency is not pegged to another currency

Short nominal rates may be derived from the rate the central bank offers for deposits. For long durations, one might consider using a global real rate plus a compensation for the inflation the local central bank is targeting. The targeted inflation may be adjusted using expert judgment if for example the risk of higher inflation on the long run is considered realistic. Observed differences in the past between the targeted inflation and the realised inflation may be an indicator for the need of an adjustment. In the globalised economy differences between real rates in developed countries have declined. See graph below. However, it might be appropriate to consider whether that narrowing will remain. For the estimation of a global real rate, an option is to use a basket of high rated government bonds or swap rates. It is a matter of judgment how much weight is put to each country. One might use for example the gross domestic product (GDP) as a weight.

Local real rates may deviate from the global real rate if there is a strong demand for loans when a country is in a developing phase. An estimation of the difference between the local risk-free real rate and the global risk-free real rate in the long run is difficult. This is a matter of judgment. Estimation of the inflation in the long run could be an even a bigger challenge. It comes largely down to expert judgment.



Note: 1 The sample consists of: United States, United Kingdom, Austria, Belgium, France, Germany, Italy, Netherlands, Norway, Sweden, Switzerland, Canada, Japan, Finland, Greece, Portugal, Spain, Australia, New Zealand. Global based on the GDP-weighted average.

Source: IMF (2014).

If quotes for forward exchange rate contracts are available, this information can be used to convert other risk-free rates in other currencies to the rate for the local currency.

3.5. How is inflation reflected in discount rates?

Paragraph B74 states that *nominal cash flows (i.e., those that include the effect of inflation) shall be discounted at rates that include the effect of inflation. Real cash flows*

(i.e., those that exclude the effect of inflation) shall be discounted at rates that exclude the effect of inflation.

Cash flows subject to inflation may therefore either

(i) be projected including the effects of inflation and discounted with a nominal rate; or

(ii) be projected without inflation and discounted with real rates.

There are several potential methods that may be suitable for deriving inflation and/or real interest rate expectations. Some potential methods and aspects to consider in their application are discussed below. The considerations listed may not be exhaustive.

- ***Market based approaches***
  - Estimating inflation by taking the difference between nominal bond yields and inflation-linked bonds. This method requires limited judgment where the issuer/ credit risk of the bonds is the same (otherwise judgment/subjectivity is involved in making further adjustments for differences in yield due to credit risk). More considerations may be required because in some markets, while the nominal bond market is considered reliable and well-functioning, the index-linked bond yields may be biased because of smaller volumes on issue and other supply/demand factors. This would then bias the derived estimate of inflation.
  - Inflation swaps/other market instruments – investment banks or other traders may offer contracts that provide exposure to future inflation. These may not be common, causing possible biases given limited availability. Where such trades occur, the prices may not be readily and publicly available. Nonetheless, where such information is available it may assist by providing insight into market information on inflation estimates.
- ***Publicly available estimates***
  - Central bank targets for inflation.
  - Forecasts of economic commentators and/or government bodies.
  - Views of a long-term real risk-free rate. This is discussed further in question 3.21. This may assist with setting the long-term inflation estimate but is likely to be less helpful in setting short-term estimates.

  Publicly available estimates may not be the same as the results of market-based approaches or may not align with realised inflation over time for the cash flows. If public estimates and market-based approaches are not similar over a given time horizon, then an evaluation of the causes of difference may be useful. The appropriate adjustments will be based on the cause of the differences.

  Potential causes of differences may be as follows:

  - The corresponding central banks may not always achieve their target which may extend to different economic expectations over the long run.

- Market based estimates can be biased due to limited volume of transactions available.

Some cash flows of an insurance contract may depend on a different inflation index to a commonly available index such as the consumer price index (CPI) and may be linked instead to salary inflation which, over time, is likely to differ from CPI. Or for example, the expenses of an insurance company may be expected to grow at a different pace than the CPI. Also, the insured amount may depend on an inflation index that is not equal to the CPI. If this is the case, the appropriate inflation expectation would need to be used in the measurement, or in accordance with paragraph B74d, where the inflation component is excluded from both the cash flows and the discount rate. Whilst projected CPI (in this example) would be considered part of financial risk for measurement purposes, where different inflation assumptions are used for expenses or other cash flows, the extent to which these inflation assumptions differ could be considered as part of non-financial risk, with implications for the determination of the risk adjustment.

3.6. Is 'own credit risk' reflected in discount rates under IFRS 17?

No, non-performance risk (defined in IFRS 13 *Fair Value Measurement*) related to the entity that has issued the insurance contract, as 'own credit risk', is not reflected (see paragraph 31) in the discount rates.

Non-performance risk with respect to reinsurance companies is accounted for in the valuation of reinsurance contracts held however.

3.7. Are investment administration expenses reflected in discount rates (or cash flows) under IFRS 17?

There is no direct guidance in the standard about this topic, but some information can be found in BC201 which states:

- *to the extent that the cash flows from underlying items affect the cash flows that arise from the liability, the appropriate discount rate should reflect the dependence on the underlying items; and*
- *to the extent that the cash flows are expected not to vary with returns on underlying items, the appropriate discount rate should exclude any factors that influence the underlying items that are irrelevant to the contracts. […] Thus, the discount rate should not capture all of the characteristics of those assets, even if the entity views those assets as backing those contracts.*

One view is that the IASB intended that only investment administration expenses that affect the return of the underlying items might be reflected in the discount rate or cash flows, but not both to avoid double counting. Investment administration expenses related to the actual investments of the company, under any other circumstances, might not be captured in the discount rate (nor the cash flow). They are irrelevant to the insurance contract.

3.8. How are yield curves updated?

Paragraph 36 requires that the discount rate be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity. Observable current market prices correspond to the value of market instruments at the reporting date and are therefore updated at each subsequent reporting period to remain current. Unobservable inputs for which estimation techniques are necessary are developed using the best information available in the circumstances. These might be updated less frequently than every reporting period. All financial assumptions used to derive yield curves are expected to be appropriate at the valuation date.

3.9. Do contracts with cash flows that vary based on the returns on financial underlying items meet the definition of insurance contracts with direct participation features and vice versa?

Contracts with cash flows that vary based on the returns on financial underlying items may meet the definition of insurance contracts with direct participation features in appendix A, but this not always the case.

Note that all contracts with direct participation features, by definition, have contractual terms that specify that the policyholder participates in a share of a clearly identified pool of underlying items. These underlying items are typically financial in nature and the contracts have cash flows that vary based on the returns on financial underlying items.

For contracts that do not meet the definition in appendix A, the GMA is used or the PAA, while for 'direct participating' contracts, the VFA is used. In this chapter, we distinguish between "cash flows that do not vary based on the returns on any financial underlying items" and "cash flows that do vary based on the returns on any financial underlying items" in order to describe the techniques deriving appropriate discount rates. A further explanation of participation features and the description of underlying items can be found in chapter 7 "Contracts with participation features and other variable cash flows".

3.10. Can an equivalent (constant) discount rate be used in IFRS 17, instead of a discount curve?

A common actuarial practice is to translate a discount curve into an equivalent discount rate by solving for a constant rate such that, for the pattern of cash flows, the present value produced by using the constant rate equates the present value produced by using the discount curve. This translation is highly dependent on the pattern of cash flows. For the same (non-flat) discount curve, different constant discount rates would result were the pattern of cash flows different. Reasons to conduct this translation include for data storage simplification and calculation ease.

Paragraph 36 requires the discount rates used to reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. If the equivalent discount rate achieves the above, then it is more likely to

comply with the standard. However, in using this method, current and future purposes of this method for which the single equivalent discount rate will be used, may need to be reflected on.

As discussed in question 3.2 there are different purposes for discount rates in IFRS 17. Many practitioners believe that to calculate the fulfilment cash flows the use of a discount curve is required to be consistent with paragraph 36. In this context, a single equivalent discount rate might provide information but is unlikely to have broader uses. See question 3.39 for a discussion of equivalent constant discount rates in the context of the locked-in curve.

Cash flows that do not vary based on the returns on any financial underlying items

3.11. How are cash flows, that do not vary based on the returns on any financial underlying items, discounted?

Paragraphs B80 to B85 establish two methods to determine rates for discounting cash flows that do not vary based on the returns of financial underlying items, the bottom-up approach (paragraph B80) and the top-down approach (paragraphs B81 to B85).

Both approaches are briefly discussed in BC196*: …(a) a 'bottom-up' approach based on highly liquid, high-quality bonds, adjusted to include a premium for the illiquidity. (b) a 'top-down' approach based on the expected returns of a reference portfolio, adjusted to eliminate factors that are not relevant to the liability, for example market and credit risk. The Board expects a reference portfolio will typically have liquidity characteristics closer to the liquidity characteristics of the group of insurance contracts than highly liquid, high-quality bonds. Because of the difficulty in assessing liquidity premiums, the Board decided that in applying a top-down approach an entity need not make an adjustment for any remaining differences in liquidity characteristics between the reference portfolio and the insurance contracts.*

Following the approach set out in BC196, a reference portfolio would need to be defined if using the top-down approach. For the bottom-up approach, an illiquidity premium has to be estimated, which may also require a reference portfolio.

3.12. What is a reference portfolio?

IFRS 17 has no specific requirements for the reference portfolio. It could be based on actual assets held by the company or on a theoretical portfolio of assets. However, the better the reference portfolio reflects the characteristics (e.g., liquidity) of the cash flows for which the discount rate is being developed, the smaller adjustments are likely to be needed in the discount rate. When starting with the actual assets held by the company, an assessment on whether the portfolio still reflects the characteristics of the cash flows whenever the investment strategy changes materially may be done.

Factors that may differ between the characteristics of a reference portfolio and that of a portfolio of insurance contracts include, but are not limited to:

i. **Investment risks**: Investment risk can consist of credit risk, market risk, and other price risks that are inherent in the reference portfolio and are not inherent in the

insurance contracts. Methods used to estimate these elements are discussed in question 3.19 (credit risk) and question 3.20 (market and other risks);

ii. **Timing**: The timing of cash flows within the reference portfolio may not be the same as that of the liability contracts. Adjustments may be considered, based on observable assets traded in active markets or on estimation techniques if the market is not active or no market exists. Estimation techniques for long duration interest rate are discussed in question 3.23;

iii. **Currency**: The reference portfolio of assets may contain assets that are in a different currency than the liabilities. One approach to adjust for the different currencies might be currency swaps.

NB: a reference portfolio is different from a replicating portfolio (paragraph B46) which exactly matches cash flows of the contract liability in amount, timing and uncertainty, for all scenarios.

3.13. How does the bottom-up approach work?

The bottom-up approach is described in paragraph B80 as:

a) liquid risk-free yield curve; and

b) adjusted to reflect the liquidity characteristics of the insurance contracts.

3.14. What are the liquidity characteristics of insurance contracts?

Paragraph 36 states that the discount rates applied should reflect the liquidity characteristics of the insurance contracts.

In order to understand the nature of insurance contract liquidity characteristics one may consider the liquidity characteristics of other financial instruments: in the context of fixed income financial instruments, liquidity is the ability to convert the asset into cash or extinguish the liability on demand. The liquidity arises from either call or put options embedded into the instrument or the marketability of the instrument.

BC193 specifically draws the parallel between insurance contracts and fixed income financial instruments and suggests that liquidity characteristics of insurance contracts be viewed from the perspective of the features embedded within the contract. This view is also echoed in the IAA Discount Rate Monograph which, on page 38 of section IV, states: *the liquidity of a liability is a function of the basic contract provisions, and especially any options that might exist for the policyholder that would impact the uncertainty regarding the amount and timing of payments.*

This answer addresses the liquidity characteristics of insurance contracts from the perspective of the contract's features. Some practitioners ask if the liquidity characteristics of insurance contracts should be assessed from the insurer's perspective. The motivation of this view is BC194 which suggests that the motivation of including a liquidity premium is the entity's ability, or lack thereof, to sell/put the contract. The focus of IFRS 17 in general is on the insurance contract features and as such this answer explores liquidity from the perspective of the contract's features.

Note that this answer focuses on qualitative assessments of insurance contract liquidity. See response to question 3.15 for a discussion on the quantitative assessment of illiquidity premium.

Contract features that may influence the liquidity of an insurance contract include:

- **Exit costs**: all else being equal, a contract with exit costs (e.g., surrender charges/ penalties) is likely to be more illiquid than one without. Note exit is contemplated as voluntary exit/cancellation of contract and occurrence of the insured event is not considered a contract exit, as contemplated in this response.
- **Inherent value/value build-up**: If a contract's pricing/construction is such that there is negligible/no inherent value then, other than any exit costs, it is likely to be considered liquid. If on exit of a contract there is:
    - little inherent value in the contract and there are no costs to exit the contract then the contract could be considered to be liquid;
    - little inherent value in the contract and there are costs to exit the contract then the contract could be considered to be illiquid.

For example, yearly renewable general insurance contracts whose design builds negligible value and are without exit costs, are likely to be considered liquid.

For contracts with no cash value, increasing risk and level premium payment, longer contract boundaries are potentially less liquid than contracts with shorter boundaries as the extended boundary potentially leads to greater inherent value/value build-up. To illustrate this a twenty-year term insurance contract could be viewed as less liquid than a two-year term insurance contract.

- **Exit value**: all else being equal, a contract where upon exit all/a large part of the value build-up is paid out is more liquid than one that pays out none or a small part of the value build-up. If on exit of a contract there is:
    - value in the contract and the policyholder receives all/a large part of the value of the contract, then the contract may be considered to be liquid.
    - value in the contract and the policyholder receives no/a small part of the value of the contract, then the contract may be considered to be illiquid.

Liability for incurred claims might be considered illiquid as there is no potential avenue for the policyholder to obtain the exit value yet there is tangible inherent value (else a claim would not have been made).

The repayment of annual premiums on exit of a contract are not considered by many practitioners to be an exit value payment as they are a repayment of prepaid premiums and not of the value build-up. In such cases, contracts with annual premiums would have similar liquidity as those with monthly premiums. Forfeiture, though, of annual premiums on exit when no penalty would have existed for monthly premium policyholders, may influence liquidity differences.

The liquidity of an insurance contract likely varies over time. For example:

- The twenty-year term insurance example could be considered to be more liquid in the contract's first year than in the contract's fifteenth year based on the growing value of initial underwriting no longer being recent.
- The contract with high cash surrender value could be viewed as less liquid in the contract's tenth year than in the contract's fifteenth year based on the exit value receivable.

For operational reasons it is conceivable that an overall assessment/categorisation be made consistent with the response in question 3.16.

One contract feature that is unlikely to affect the liquidity of insurance contracts is the predictability (or lack thereof) of the contract's cash flows. The risk adjustment for non-financial risk reflects the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk.

An environmental feature that is unlikely to influence the liquidity of a contract is the potential for viatical settlements. Viaticals provide policyholders, who may not place a high value on any remaining death benefits, with a payment from a third party for their contract where no or little exit value might exist as part of the contract feature. However, since the contract features remain unchanged and assuming that the insurer's required payment is only made upon occurrence of the insured event, the existence and depth of a viatical market would seem to affect the calculation of probability weighted cash flows and would not seem to affect the contract's liquidity.

3.15. How can the liquidity characteristics of insurance contracts be quantified?

The adjustment to reflect the liquidity characteristics of the insurance contracts has been broadly termed the illiquidity premium. Highly liquid insurance contracts would have a low (or even no) illiquidity premium while very illiquid contracts would have a higher illiquidity premium.

Data relating to illiquidity premium of insurance contracts is generally not directly available in the market. Looking beyond insurance contracts, market prices for liabilities where the issuer of debt has the possibility to redeem the debt early are also very limited.

A theoretical approach to determine the illiquidity premium is to assess possible replicating portfolios. This is discussed in question 3.29. Some practical approaches of estimating illiquidity premiums for insurance contracts include:

- Using a reference portfolio and determining its illiquidity premium using top-down techniques (see questions 3.18 to 3.20); and
- Comparing yields on illiquid and liquid assets, both with the same or similar degree of credit risk. The commonality in these approaches is that the instruments are considered to have the same degree of credit risk and as such the spread difference would be largely attributable to liquidity. For example:

- Covered vs risk-free bonds: Covered bonds are illiquid bonds which are backed by collateral and as such, are considered safe;
- Public and private debt issued by the same issuer; and
- Highly liquid and less liquid mortgage backed securities.

If the asset portfolio used in estimation is more liquid than the insurance contracts being considered, then additional adjustments may be needed. The illiquidity premium of insurance contracts may be different from market assets. However, this is dependent on the contract itself.

What follows is an example of a simple method used to relate the illiquidity premium of insurance contracts to the asset portfolios:

> *Assume liability illiquidity premium = r * asset portfolio illiquidity premium + constant illiquidity premium difference* where the constant term and multiplicative factor (r) is set based on either judgment or data if any is available. In the selection of the factor differing market environments may be taken into consideration. For example, using a high multiplicative factor (r) and a constant = 0 may not produce a convincing result during a credit crisis. It would be difficult to justify insurance contracts having a higher illiquidity premium than the return on assets available for investment earning the illiquidity premium. This, however, is not a directly relevant factor in setting the illiquidity premium level.

The above approach is based on a top-down approach. For those using bottom-up there may be a discernible relationship between the level of the illiquidity premium and other market data such as the level of risk-free rates and/or the level of credit spreads. For example, there may be a different illiquidity premium in a 10% rate environment than in a 5% environment. However, if analysis showed the same level of credit spreads in these disparate environments then the level of illiquidity premiums in these environments might be the same.

Little is known about the term structure of illiquidity premium in current research and it is expected to be a function of the modelling approach selected. One reference that discusses the term structure of the illiquidity premium is (Kempf, 2011). Note that if the liquidity characteristics vary over time, then the implicit illiquidity premium in the discount rate would also be expected to vary over time. However, materiality/modelling and operational considerations may also influence approach choice.

An important caveat in setting the illiquidity premium is discussed in paragraph B90 which states the discount rates should not include any implicit adjustments for non-financial risk. The illiquidity premium corresponds to the estimate reflected in the future cash flows while uncertainty attributable to non-financial risk is reflected in the risk adjustment for non-financial risks. In calculating these values, paragraph B90 states that double counting should be avoided.

3.16. Are different products expected to have different illiquidity premiums?

Insurance contracts exhibiting different features may have different exit costs, inherent value and/or exit value. As such, products are expected to have different illiquidity premiums. Products within the same portfolio, however, may have similar illiquidity premiums/characteristics since they are similar risks. An entity may elect to use a single average illiquidity term structure across products within a given portfolio.

3.17. If a contract is reinsured, would the direct issuer use the same illiquidity premium when valuing the direct and the ceded contract?

NB - the illiquidity premium from the reinsurer's perspective is not in scope for this question as it would be determined in accordance with the previous questions.

Paragraph 63 states that "*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*".

This consistency is required to the extent that both the underlying contracts and the reinsurance contracts share the same characteristics. This requirement does not necessarily permit the entity to use the same assumptions used for measuring the underlying contracts when measuring the reinsurance contracts if those assumptions are not valid for the terms of the reinsurance contracts held. If different assumptions apply for the reinsurance contract, the entity uses those different assumptions when measuring that contract.

For example, consider a coinsurance contract where a predetermined proportion of all the direct contract characteristics are transferred to the reinsurer. In that particular case, one could expect the direct and ceded insurance contracts to exactly have the same illiquidity premium. On the other hand, consider a level premium term life insurance contract for which only mortality risk would be reinsured on a yearly renewable term basis. In this case, the direct and the reinsurance contracts have different characteristics and a different illiquidity premium would apply. Overall, in this example, the yearly renewable reinsurance contract would be expected to be more liquid than the level premium direct contract.

3.18. How does the top-down approach work?

An entity may determine appropriate discount rates for insurance contracts using a top-down approach (paragraph B81). Under this approach, discount rates are based on current market rates of return of a reference portfolio of assets which are adjusted to remove risk characteristics embedded within the reference portfolio but that are not inherent in insurance contracts. These adjustments are discussed in questions 3.19 and 3.20.

IFRS 17 does not require that adjustments to the yield curve be made for residual differences in liquidity characteristics of the insurance contracts and the reference

portfolio. Nonetheless, an entity may still adjust the yield curve for these differences, as discussed in questions 3.14-3.17.

3.19. How could the reference portfolio be adjusted for credit risk[11]?

For debt instruments, the effect of credit risk would need to be eliminated from the total bond yield. The effect of credit risk usually comprises two components: the expected credit losses and the unexpected credit losses (i.e., compensation for bearing that risk). There is a wide range of practices used to estimate the required deduction for credit risk inherent in bond yields. Observed practices include:

i. ***Market-based techniques:*** Credit default swap (CDS) spread, where available, is used as a measure of the inherent credit risk in bonds and comprise the expected as well as the unexpected credit losses. An advantage of this approach is that the inherent bond credit risk is directly and instantly reflected in the CDS spread. A disadvantage is that it may capture additional risks (e.g., counterparty credit risk) and costs and, as such, may overestimate the bond credit risk. On the other side the CDS premium reflects the possibility that the CDS provider may default – and therefore the CDS premium is lower than it would be were this not the case – and therefore the CDS could underestimate the bond credit risk (where this is the case it can result in the illiquidity premium being overestimated).

ii. ***Structural-model techniques*** such as the Merton Model, Leland and Toft Model and EDF-Based Model. These models put in relation the capital structure of a company to an option on the equity of the same company and the value of its debt. For further information see the IAA Discount Rate Monograph Section IV and Agrawal, Arora and Bohn.

iii. ***Expected/Unexpected Credit Loss (ECL / UCL) models***: ECL models usually comprise an estimation of the probability of defaults (including the future cost of downgrades) and an estimation of the loss given default. One could leverage on models developed for calculating the IFRS 9 lifetime impairment provision (e.g., panel logit models, dynamic transition matrix models). Usually based on historical information, point-in-time adjustments might be needed to calibrate estimations to current economic situation and forward-looking information (e.g., factor ratio models, scorecard models). UCL models are based on an adjustment to reach a selected percentile credit loss level (confidence level approach). UCL could also be estimated as the compensation required by an investor to bear the credit risk associated with the instrument (cost of capital approach).

NB: several of the above approaches used to estimate the deduction for credit risk are complex and as such it has been observed that insurers have typically simplified expressions for the deductions required for credit risk and calibrating these expressions based on the above approaches. Examples of such expressions include:

[11] Consistency with what the entity is doing under IFRS 9 (impairment provisions), might be discussed later.

a. Deduction for credit risk = Expected Default Rate + X% (Total Bond Spread – Expected Default Rate)

b. Deduction for credit risk = X% (Total Bond Spread)

c. Deduction for credit risk = Expected Default Rate * (1+compensation risk)

The advantage of the first two approximations is that the credit risk premium changes as a function of the corporate spread.

3.20. How could the reference portfolio be adjusted for market and other risks?

As mentioned in paragraph B85, IFRS 17 does not specify restrictions on the reference portfolio of assets used in applying paragraph B81. For example, equity or real estate investments may also be considered in the reference portfolio. However, the estimation process may be much more challenging since many risks are specific to these investments and not necessarily related to the insurance contract characteristics. Such risks include, but are not limited to, market risk, variability in amount and timing of dividend, the risk of delay in finding a new tenant, obsolescence and unexpected deterioration.

Other market factors, such as market sentiment and market inefficiencies, influence the reference portfolio assets and might result in some fluctuations in the overall spread. Unless measured and treated separately, these factors might be attributed to the illiquidity component of the asset yield and hence would also be included in the liability discount rate.

3.21. How should the yield curve duration be extended beyond available market data?

In constructing the discount curve, a core principle is that the discount rates are consistent with observable market prices. If liability cash flows extend beyond a certain point, such discount rates may not be directly observable in the market, or market data for certain durations could be scarce. An entity may then choose to estimate appropriate rates beyond those observable in the market by interpolating between data points that are observed directly in the market, and between observable data points and rates estimated beyond the observable term structure. There are many potential interpolation approaches that can be used to derive a yield curve using interpolation and extrapolation techniques. In chapter V of the Discount Rate Monograph some examples of possible approaches of interpolation and extrapolation are presented.

In applying an estimation technique, as per B78, *an entity shall maximise the use of observable inputs and reflect current market conditions from the perspective of a market participant.*

3.22. When does the observable market end?

The determination of the end of the observable market is a function of the financial market being considered and as such is potentially affected by whether the top-down or bottom-up approach is elected.

- For example, if the top-down approach is adopted and the reference portfolio comprised of debt instruments then the end of the observable market in the context of those debt instruments might need to be considered.
- Alternatively, if the bottom-up approach is adopted and the risk-free curve is based on government bonds then the end of the observable market in the context of those government bonds may be considered. If the risk-free curve is based on swap rates, then the end of the observable market in the context of swap rates in that currency may be considered.

In general, IFRS 17 requires the use of market data when available. For example, if the market for the available financial instruments in the reference portfolio would end after 10 years and market data is available for a bottom up approach up to 30 years, the entity might need to consider the suitability of using a top-down approach.

Once the financial market of interest has been determined, the longest duration is determined at which the market data is both available and relevant. Market data for longer durations can be used if market prices are available. The following criteria might be looked at to perform this assessment:

- availability of financial instruments;
- bid-offer spread;
- trade frequency; and
- trade volume.

For example, in a given market, 1, 3, 5, 7, 10, 20 and 30-year instruments may be available and 50-year instruments may infrequently be traded. In this example, since the 50-year instrument is infrequently traded, ~~the market might not be considered active~~; data at the 50-year point is unlikely to be considered available and relevant for construction of the curve. The core premise in determining the end of the observable market is determining the last point at which "available and relevant" market data exist for construction of the yield curve, consistent with paragraph B78.[12]

In the bottom-up approach, it may be difficult to split the spread on the reference portfolio that is used to derive the illiquidity premium between a credit spread and an illiquidity premium. This may be especially challenging for longer durations. In those situations, estimation techniques might be used for this split. In the top-down approach, the current credit spread, excluding an illiquidity premium, is needed to determine the discount rate. Also, here the split between credit spread and illiquidity premium has to be determined and for longer durations a separate credit spread is not available and estimation techniques might be used.

[12] In other frameworks, such as Solvency II, a similar concept is referred to as the "last liquid point", however IFRS 17 guidance does not contain this phrase.

3.23. Which assumptions can be made for long durations where there is not enough market observable data?

The following two approaches are often used:

- extrapolation based on last observable constant rate; and
- extrapolation of the last observable rate to an ultimate rate.

NB: there may be other approaches that are not considered here.

Extrapolation techniques based on the last observable constant rate have the advantage of simplicity and are based on the last observable information. On the other hand, using an ultimate rate might have the advantage of including additional market participant inputs (such as economic expectations) and may be considered more consistent with paragraph B82(c) (i.e., more weight on long-term estimates than on short term fluctuations). Setting an ultimate level is discussed in question 3.24.

The rates to be used and derived can either be expressed as forward rates or as spot rates. The use of one form or the other requires some expert judgment and can be translated back in the other form. Forward rates are frequently used to represent future implicit market rate expectations. Spot rates are generally used to derive today's market price of a future cash flow. The final assumed curve may be expressed in both forms to ensure it is balanced with market reasonable expectations (e.g., it may be desirable to avoid important jumps and/or cliffs). One of the criteria commonly adopted by finance practitioners and academics for judging yield curve construction is that forward rates are continuous. Reasons for this include that discontinuity in forward rates implies either implausible expectations about future short-term interest rates, or implausible expectations about holding period returns (McCulloch and Kochin [2000], J. Huston McCulloch and Levis A. Kochin).

In any extrapolation model, the level and position of the end points are required. As such, the year at which the ultimate rate is achieved needs to be set, and would depend on considerations related to how the ultimate rate was derived. It is interesting to note that if the same assumption is used, an ultimate spot rate would require a much longer convergence period than an ultimate forward rate in order to produce equivalent results.

3.24. How is the ultimate rate level set?

In the process of setting the ultimate rate, both retrospective and prospective approaches might be considered. According to paragraph B44 "*Estimates of market variables shall be consistent with observable market prices at the measurement date. An entity shall maximise the use of observable inputs and shall not substitute its own estimates for observable market data"*. Further, the information used in the estimation would need to be appropriate for the expectations for the long durations of the ultimate rate.

A retrospective approach has the advantage of simplicity. However, macroeconomic fundamentals may have changed over time. Furthermore, the choice of the starting point could be considered to be arbitrary. The observed period may be chosen to be long enough to eliminate or significantly reduce cyclic effects. Examples of retrospective

approaches include using an arithmetic mean (with assumed underlying normal distribution) or a geometric mean (with assumed underlying lognormal distribution) of the historical nominal interest rate or real-rate.

A very simple prospective approach would be to use the forward rate or spot rate at the last liquid point. Another approach might be to make use of well-known economic metrics reflecting market participant expectations. Examples are the central bank inflation target or neutral rates[13] and OECD GDP growth forecasts.

One might also want to use historical observations and adjust them to obtain a realistic rate in a prospective approach. Economists have studied the decrease of the real interest rates around the world over the past decades e.g., (Rachel, 2015). Depending to which extent the economy of a country or currency is open, global developments influence the local interest rates. Some argue that there is a global long term real risk-free rate and that differences in the nominal rates are only caused by differences in the targeted inflation rate of the central banks. Others point to differences in the long-term rates between currencies that are difficult to explain. The decline in the real rate is a global trend however. Understanding this trend may help in setting prospective assumptions. Rachel (2015) identifies possible causes of the decline in the long-term rate. Some of them may revert and cause the real rate to increase, while others are unlikely to revert.

Due to increasing globalisation, real rates across groups of countries with similar economic environments have the tendency to be closer together. See also question 3.4. As such, for these countries the same ultimate real rate may be used for liabilities with similar liquidity characteristics. The nominal rates have to be corrected for inflation. This might be the inflation targeted by the central bank.

Cash flows that vary based on the returns of any financial underlying items

3.25. Why is it important to distinguish between the nature of the dependency between cash flows and underlying items?

Cash flows may depend on the return of financial underlying items[14]. It is important to distinguish between a linear and a non-linear dependence. A non-linear dependence can be, for example, caused by a combination of dependence of the cash flows on the return of financial underlying items and a guarantee on the return of those financial underlying items. The valuation approach to be used in the situation of a linear dependence is discussed in question 3.26 and the valuation approach to be used in the situation of a non-linear dependence is discussed in question 3.27.

[13] The neutral (or natural) rate of interest is the rate at which real GDP is growing at its trend rate, and inflation is stable. It is attributed to Swedish economist Knut Wicksell, and forms an important part of the Austrian theory of the business cycle.

[14] As stated before, one must be careful in distinguishing cash flows that do and do not vary based on the returns on any financial underlying items.

3.26. How are cash flows, that do vary based on the returns of any financial underlying items, discounted?

Paragraph B74 (b) provides guidance for cash flows that vary based on the returns on any financial underlying items. These cash flows shall be:

(i) discounted using rates that reflect that variability; or

(ii) adjusted for the effect of that variability and discounted at a rate that reflects the adjustment made.

This means that projection assumptions should be consistent with discounting to ensure an appropriate approach whether deterministic or stochastic methods are used. Deterministic methods are possible where there is linear dependence, i.e., where the insurance contract has no embedded options or guarantees.

Under (i), cash flows are projected based on the expected risky returns of the financial underlying items. If the dependence is linear, this might be done using a deterministic real-world projection rate (or curve), i.e., including a risk premium. In that case, the discount rate (or curve) to be used shall reflect that variability, and thus, also include a risk premium.

Under (ii), cash flows are adjusted for the effect of that variability. Again, if the dependence is linear, one might project cash flows using investment returns implied by a deterministic risk-free rate (or curve). In that case, the discount rate (or curve) to be used shall also be on a risk-free basis.

Both approaches avoid any valuation mismatch and double counting, since the discount rate is consistent with the rate used for the cash flow projection. Theoretically, both valuation approaches are expected to lead to the same result.

3.27. What approaches can be used if the dependence of the cash flows on the financial underlying items is non-linear?

As discussed in paragraph B76, cash flows could vary with returns on financial underlying items, but be subject to a guarantee of a minimum return. These cash flows do not vary solely based on the returns on the financial underlying items, because there might be some scenarios where the cash flow will not vary based on the financial underlying items, e.g., when the guarantees are in-the-money. This is an example of a non-linear dependence.

Here are some approaches (but not an exhaustive list) that might be used in the valuation if the dependence of the cash flows on the financial underlying items is non-linear (paragraph B77), noting the requirement for the measurement to be consistent with observable market prices (paragraph B48):

- Stochastic modelling techniques based on risk neutral scenarios for investment returns on underlying items[15]. In this technique, the projected average investment

[15] IAA Monograph: Stochastic Modeling Theory and Reality from an Actuarial Perspective (2010).

returns on the financial underlying items are calibrated to be equal to the deterministic risk-free discount rate (with adjustment for liquidity as appropriate). In each scenario, the net present value is calculated. The value of the cash flows of the insurance contract is equal to the average of the net present values of all scenarios.

- Stochastic modelling techniques based on real world scenarios for investment returns on underlying items. The financial underlying items are projected on a stochastic real-world basis. The discounting is done with a stochastic real-world deflator set, which is a set of interest rates that ensures the same valuation outcome as using risk neutral scenarios. (See IAA Monograph on Stochastic Modeling[8].) Also, in this approach, the net present value is calculated for each scenario. The value of the cash flows of the insurance contract is equal to the average of the net present values of all scenarios.
- Replicating portfolio techniques (paragraphs B46 and B47). These are discussed in question 3.29.
- A closed form solution might also be used where this exists depending on the nature of non-linear dependence.

3.28. When do cash flows need to be disaggregated?

Paragraph B77 states that an entity is not required to divide estimated cash flows into those that vary based on the returns on financial underlying items and those that do not. If it does not, it shall apply discount rates appropriate for the estimated cash flows as a whole; for example, using stochastic techniques.

In some cases, it might be easier to disaggregate cash flows than to apply discount rates appropriate for the estimated cash flows as a whole. One example might be a life insurance contract that provides a fixed death benefit plus the amount of an account balance if the insured person dies, and the account balance if the contract is cancelled. In this case, dividing the cash flows and applying different approaches might be practical for cash flows that vary based on the returns on financial underlying items vs those that do not.

In some other cases, it might be easier using stochastic techniques than trying to divide the cash flows. This could be the case when cash flows do vary with returns on financial underlying items but are subject to a guarantee of a minimum return.

3.29. How can replicating portfolios be used?

Paragraph B46 states that "*an important application of market variables is the notion of a replicating asset or a replicating portfolio of assets. A replicating asset is one whose cash flows* exactly *match, in all scenarios, the contractual cash flows of a group of insurance contracts in amount, timing and uncertainty. […] If a replicating portfolio [of assets] exists for some of the cash flows that arise from a group of insurance contracts, the entity can use the fair value of those assets to measure the relevant fulfilment cash flows instead of explicitly estimating the cash flows and discount rate.*"

It might not be possible to find a replicating asset that exactly matches the insurance contract cash flows in all scenarios. Nonetheless, replicating assets may exist for some of the cash flows that arise from insurance contracts. One may also strive to find a portfolio of assets that will reproduce characteristics of some insurance contracts. As per paragraph B48, judgment is required to determine the technique that best meets the objective of consistency with observable market variables in specific circumstances. The general process might start with the simplest method and progresses to the use of more involved methods as necessary.

For example, such techniques might include the following assessments of insurance contract cash flows while maintaining non-financial risk assumptions at expected values:

i. **Asset cash flow matching**: Insurance contract cash flows are replicated in terms of amount and timing with available asset cash flows. This method is similar to building a reference portfolio.

ii. **Optimisation**: Assets are then chosen to match, as closely as possible, the key financial risk metrics related to these cash flows (e.g., duration matching).

iii. **Dynamic replication**: Stochastic valuation techniques are used to derive risk-factor sensitivities for the insurance contract cash flows that can be replicated directly.

The choice of method depends primarily upon the nature and complexity of the asset or liability under consideration and the purpose of the replicating strategy. For example, if the asset or liability is relatively simple, it might be possible to identify a pure replicating portfolio (e.g., capital guaranteed equity product and a vanilla European equity option). However, for more complex assets or liabilities, such corresponding assets may not exist, even theoretically. In this case, optimization techniques might be used to match the financial risk metrics as close as possible (e.g., path-dependent guarantees proxied using a portfolio of vanilla and exotic options). In other complex cases, optimization techniques may deliver poor results, hence the need to make use of dynamic replication techniques.

3.30. How is the discount rate adjusted for illiquidity if cash flows do vary based on the return of financial underlying items?

The response to questions 3.14 to 3.17 explain the assessment of contract liquidity and the resulting application of liquidity premiums in discount rates.

Consistent with paragraph B74 (b), if the cash flows that vary based on the return of financial underlying items are based on a projection of returns that include an illiquidity premium, this illiquidity is logically also reflected in the discount rate. If the cash flows that vary with the return on financial underlying items are projected without an illiquidity premium, the discount rate is chosen accordingly.

Cash flows that accrue to the holder of an insurance contract may depend on a combination of the return on financial underlying items, a guarantee on the return of the financial underlying items and other insurance cash flows subject to non-financial risk. All

the following elements contribute, depending on their significance in the value of the cash flows, to the overall illiquidity:

- the illiquidity premium from the financial asset underlying the contract that is passed to the policyholder in so far it is included in the projection;
- the guarantee on the return of the financial underlying items; and
- other insurance cash flows subject to non-financial risk.

The requirement for consistency with observable market prices (paragraph B48) implies that any liquidity premium adjustments made in the valuation of options and guarantees would need to be followed by a consideration of the calibration of stochastic models to ensure that market consistency is maintained.

As discussed in question 3.15, the risk adjustment reflects the uncertainty of non-financial risk and is distinct from the other fulfilment cash flows which can be discounted using a discount rate that is appropriately adjusted to reflect liquidity characteristics.

3.31. How is the present value of future cash flows adjusted for financial risk?

In a market consistent projection, either using risk-neutral or real-world techniques with deflators, market variables associated with future cash flows are calibrated to be consistent with observable market prices (as required by paragraph B44). This ensures that the cash flows are implicitly adjusted for financial risk in a matter consistent with the pricing of financial instruments. This implicit adjustment for financial risk is released over the duration of the contract and accounted for as financial risk.

Premium Allocation Approach (PAA)

3.32. Under which circumstances is discounting required for a group of contracts subject to the PAA in measuring the liability for remaining coverage?

If the entity uses the PAA for a group of insurance contracts, as per paragraphs 53-59, discounting is only required in special circumstances in the liability for remaining coverage:

- For a group of contracts with a significant financing component where the PAA is applied, unless, at initial recognition, the entity expects that the time between providing each part of the coverage and the related premium due date is no more than a year (paragraph 56); and
- For contracts that have become onerous (paragraph 57), unless time value of money for the liability for incurred claims is not considered under paragraph 59.

3.33. When required, which discount rates are used for the liability for remaining coverage for contracts that have a significant financing component within a group of contracts where the PAA is applied?

For the liability for remaining coverage of contracts with a significant financing component within a group of contracts where the PAA is applied, as per paragraph 56, the

cash flows might be discounted. The discount rate is always the locked-in rate at inception of the contract (paragraph B72(d)).

3.34. When required, which discount rates are used for onerous contracts where the PAA is applied?

If the group of insurance contracts becomes onerous (as per paragraph 57 (b)), the difference between the carrying amount of the liability using PAA (paragraph 55) and the fulfilment cash flows that relate to remaining coverage of the group ~~GMA~~ (applying paragraphs 33-37 and paragraphs 86e-92) should be calculated. The calculation of liability values under the GMA is conducted at either the current rate or the locked-in rate at inception of the contracts for the P&L if the OCI option is used (questions 3.36–3.41).

3.35. When required, which discount rates are used for the liability for incurred claims?

For incurred claims, discount rates are used unless cash flows are expected to be paid or received in one year or less from the date the claims are incurred then GMA is used without a CSM, which is not applicable for the liability for incurred claims. The calculation of liability values under the GMA is conducted at the current rate for the balance sheet or at the locked-in rate for the P&L if the OCI option is used. If the PAA is used, the locked-in rate at the date of the incurred claim is used. If the GMA is used, the locked in rate is determined at the date of the inception of the contract.

Locked-in rates

3.36. What interest rate is accreted on the CSM?

For contracts without direct participation features, the interest rate accreted on the CSM is based on the discount rates determined at initial policy recognition for cash flows that do not vary based on the return of financial underlying items (paragraph B72(b)). It may include an illiquidity premium. This is referred to as the locked-in curve.

IFRS 17 is not specific regarding the method to roll forward the curve. One approach might be to derive each year's discount factors with the forward rate for that year, from the locked-in curve. This forward rate would be the rate to accrete on the CSM.

If there are direct participating features, the entity's share of the profit is discounted using current rates (paragraphs B74b).

3.37. What interest rate is used to measure the changes in the CSM?

For contracts without direct participating features in the contract, the interest rate used to measure the changes in CSM is the same as the interest rate described in question 3.36. It is the interest rate accreted on the CSM is based on the discount rates determined at initial policy recognition for cash flows that do not vary based on the return of financial underlying items.

If the VFA is used, changes are measured using the current rate.

3.38. What is the locked-in yield curve when the OCI option is used for groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders?

For groups of insurance contracts for which changes in assumptions that relate to financial risk *do not* have a substantial effect on the amounts paid to policyholders, and the OCI option is used, the change in the present value of the cash flows presented in the P&L is based on the locked-in curve. That means that the discount rates are determined on the yield curve at the date of initial recognition of the group of contracts or the date of the claims (paragraphs B72 (e)(iii)), applying paragraph 36 to cash flows that do not vary based on the returns on any financial underlying items.

3.39. What is the locked-in rate for groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to policyholders?

These contracts typically have participating features, but fail to meet the definition of "direct participating" contracts. If the entity plans to recognise insurance finance income or expenses in OCI, discount rates are used that allocate the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate[16]. (Paragraphs 88(b) and B132).

3.40. Can a single equivalent discount rate be used instead of the locked-in discount curve?

See question 3.10 for introductory context.

The locked-in curve is determined at initial recognition and if it were to be translated into a locked-in constant rate the pattern of cash flows at initial recognition would presumably be used in the derivation. Potential challenges that may occur in the subsequent use of this locked in rate are as follows:

- One purpose of the locked-in discount curve is to measure the changes to the CSM for insurance contracts without direct participation features. A change to the CSM would only arise if the pattern/level of cash flows was altered. Since the locked-in constant rate at inception would be derived based on the pattern of cash flows at inception application of this rate to an altered pattern of cash flows may be inappropriate. To gauge the materiality a comparison of the originally derived locked-in rate and the revised locked in constant rate based on the new pattern of cash flows would be required.
- Another purpose of the locked-in discount curve is to accrete interest on the CSM. Given this different purpose, the use of the locked in constant rate based on the pattern of liability cash flows may be inappropriate for interest accretion. Rather a locked-in discount rate based on equating the expected CSM interest accretion may be more relevant. Further challenges similar to the above may be encountered

[16] See also example 15 of the illustrative examples.

when the pattern/level of liability cash flows changes, changing the CSM and potentially the equivalent locked-in discount rate.

3.41. How is the average locked-in curve determined for a group of contracts?

The discount rate for the calculation of the CSM at issue for contracts in a group could be determined in, amongst others, any of the following ways.

a. Calculating the CSM at issue for each contract within the group using the discount curve at each contract's respective issue date – i.e., a single curve would not be used. This, however, might be an impractical implementation option.

b. Calculating the CSM at issue for the group of contracts as at the date of initial recognition using the discount curve as at the date of initial recognition. This is thought to be consistent with IFRS17 because the standard refers to the date of initial recognition for the group and not the date of initial recognition of individual contracts. See paragraph 25 for the definition of the date of initial recognition of a group.

c. Calculating the CSM at issue for the group as at the date of initial recognition using a weighted average discount curve (paragraph B73). To apply this approach suitable weights would need to be defined as they are not specified in the guidance. One potential option for weighting might be to use the measure of coverage units. Note that as per paragraph 22 the date of initial recognition should not include more than one year.

The methodology for calculating the locked-in curve across one or more reporting periods would be driven by the option chosen above. As per paragraph B73 a weighted average discount curve might be created with a potential option that might exist for weighting being the measure of coverage units.

- If options a. or c. above were chosen then the locked-in curve would be a weighted average curve of the specific curves used (i.e., the curves to be weighted would be from the actual issue dates).
- If option b above was chosen, then the locked-in curve would be a weighted average curve of the curves at the date of initial recognition. That is, there would only be a single curve based on a single day from each reporting period which would then be weighted using the selected measure.

When calculating weighted average discount curves, one approach might be to average discount factors.

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Chapter 4 – Risk Adjustments for Non-Financial Risks

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

4.A. What does this chapter address?

This chapter considers the criteria and measurement of the risk adjustment for non-financial risk required as part of the general measurement approach under IFRS 17 including the purpose and general requirements of the risk adjustment, what risks would typically be covered and specific considerations in determining the risk adjustment. This note discusses how to reflect risk mitigation such as diversification and risk sharing, catastrophic and other infrequent events, qualitative risks considerations, use of different approaches by line of business, and general considerations in selecting and calibrating a risk adjustment approach. For detailed risk adjustment methods and how to apply them, reference is made to the IAA Monograph on Risk Adjustments. This chapter also covers high level disclosure requirements including confidence level disclosure, and issues around allocation of risk adjustments to a lower level.

In this chapter, the term "risk adjustment" refers to the "risk adjustment for non-financial risk", as defined in IFRS 17. In other contexts, risk adjustments may be referred to as risk margins.

4.B. Which sections of IFRS 17 address this topic?

Paragraphs 37, 81, 101, 117-119 and B82–B92 provide guidance on this topic.

BC206–217 also provides background on the subject.

4.C. What other IAA documents are relevant to this topic?

To support the selection of an approach or approaches for estimating the risk adjustment, an educational *IAA Monograph: Risk Adjustments under IFRS 17* has been produced. The main intention of the monograph is to provide focus on methodologies and approaches, to document and build on common approaches that have been developed so far, and to explore ways in which IFRS 17's entity-specific approach may be incorporated into them.

4.1. What is a risk adjustment?

Under IFRS 17, insurance contract liabilities are principally measured as defined in paragraph 32:

"*On initial recognition, an entity shall measure a group of insurance contracts at the total of:*

(a) the fulfilment cash flows, which comprise:

(i) estimates of future cash flows (paragraph 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 paragraph 38–39."

The "risk adjustment for non-financial risk" is a defined term in IFRS 17.

Appendix A states "*the compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts*". A similar definition is also included in paragraph 37.

This chapter primarily discusses the risk adjustment for non-financial risk of insurance contracts accepted by the entity. The risk adjustment for ceded reinsurance (referred to as reinsurance held in IFRS 17) is governed by paragraph 64. The application of risk adjustments for ceded reinsurance is discussed in chapter 9 – Reinsurance of this IAN.

4.2. What is the purpose of the risk adjustment in IFRS 17?

Paragraph B87 states:

The risk adjustment for non-financial risk for insurance contracts measures the compensation that the entity would require to make the entity indifferent between:

(a) fulfilling a liability that has a range of possible outcomes arising from non-financial risk; and

(b) fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts.

As such, it measures the value of a liability, related to unexpected costs, that the entity places on the uncertainty and variability (see question 6.6) inherent in insurance cash flows. As IFRS 17 provides only the principles regarding how this should be done, it will be important to those who determine and rely on such values that the quantification of such a liability value be based on methodologies and/or approaches that are robust and are a fair reflection of this value.

As most users only see what is published in the entity's financial statements, it is important that these liability values, and changes in such values, are based on an adequate understanding of the basis on which the risk adjustment is determined and of any changes in that basis. This understanding will underlie the entity's ability to provide appropriate disclosures as required by IFRS 17. The entity's understanding will enhance its communications, enable consistency to be recognised and allow relevant comparisons to be made, as appropriate.

An important aspect of the communications among those responsible for determining an entity's risk adjustment is the explanation and insight regarding how the entity's views with respect to the compensation it requires for bearing risk and uncertainty has been incorporated in the determination of the risk adjustment. Such communications will be expected to reflect a thorough understanding of the entity's views with regards to risk aversion, risk diversification and the uncertainty surrounding the values being estimated.

4.3. What are the IFRS 17 requirements for risk adjustment?

IFRS 17 does not provide guidance on appropriate techniques and methods to set the risk adjustment. In paragraph 37, it simply requires that:

"An entity shall adjust the estimate of the present value of the future cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk."

The application guidance states, in paragraph B91, that a risk adjustment should possess the following five characteristics:

(a) "risks with low frequency and high severity will result in higher risk adjustments for non-financial risk than risks with high frequency and low severity;

(b) for similar risks, contracts with a longer duration will result in higher risk adjustments for non-financial risk than contracts with a shorter duration;

(c) risks with a wider probability distribution will result in higher risk adjustments for non-financial risk than risks with a narrower distribution;

(d) the less that is known about the current estimate and its trend, the higher will be the risk adjustment for non-financial risk; and

(e) to the extent that emerging experience reduces uncertainty about the amount and timing of cash flows, risk adjustments for non-financial risk will decrease and vice versa."

It should be noted that the risk adjustment relates only to non-financial risks inherent in the insurance contract and its cash flows. Paragraph B86 states that

"*The risk adjustment for non-financial risk relates to risk arising from insurance contracts other than financial risk. Financial risk is included in the estimates of the future cash flows or the discount rate used to adjust the cash flows. The risks covered by the risk adjustment for non-financial risk are insurance risk and other non-financial risks such as lapse risk and expense risk (see paragraph B14).*"

Risks reflected through the use of market consistent inputs are excluded. ~~Other~~ Non-financial risks that may not arise directly from the insurance contracts, such as asset-liability mismatch or general operational risks, should not be reflected in the risk adjustment for non-financial risks. (See question 4.7 for a fuller discussion of which non-financial risks are considered.)

This general guidance means that there is no single right way for an entity to set the risk adjustment. In general, there are other important considerations that will be relevant to how an entity determines its approach to estimating the risk adjustment:

- consistency with how the insurer assesses risk from a fulfilment perspective;
- practicality of implementation and ongoing re-measurement; and

- translation of risk adjustment for disclosure of an equivalent confidence level measure.

Therefore, a variety of methods are potentially available, although their ultimate usage depends on the extent to which they meet the criteria above, given the specific circumstances of the company. Potential methods include, but are not limited to, quantile techniques such as confidence level or CTE, cost of capital techniques, or even potentially simple techniques such as directly adding margins to assumptions or scenario modelling.

There are also disclosure requirements related to the risk adjustment (see question 4.15) and chapter 15.

4.4. What is the role of actuarial input on risk adjustment?

In actuarial terms the risk adjustment is intended to reflect the value of the uncertainty inherent in the insurance cash flows under the contract. It is expected that actuarial input, both quantitative and qualitative, will be needed.

This actuarial input falls into four parts and can:

- assist in understanding and assessing the risk aversion of the entity (its attitude toward risk see questions 6.9 and 6.10), as it relates to the uncertainty and variability of insurance cash flows, and in understanding the extent to which the entity considers "*the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk*" [paragraph B88(a)].
- provide quantitative measures to help evaluate the variability inherent in the insurance contracts being valued and the uncertainty which underlies such quantitative measures.
- assist in designing an approach to assess a value in terms of the compensation for bearing risk that reflects the entity's risk aversion, in the context of the relevant risks, and in the context of the diversification affecting the compensation for such risks.
- provide explanations and insights to help in communicating the understandings and judgments involved, such that the entity's board and management can have the appropriate level of direction and oversight regarding how the risk adjustment is determined.

4.5. What is the role of judgment in estimating the risk adjustment?

Judgment may be needed for a variety of reasons including, but not limited to:

- in the selection of the approach to estimate the risk adjustment,
- in the assessment of the entity's risk aversion,
- in the estimation and assessment of variability and uncertainty, depending on the data available,

- in the assessment of diversification, depending on the complexity of the business written, and
- in the assessment of how risk aversion interacts with variability and uncertainty in the determination of the risk adjustment.

In general, it will be important that the entity's board and management properly understand the process and the judgments used to determine the entity's risk adjustment and how their oversight and management roles and responsibilities are being satisfied.

4.6. What does "risk" mean in this chapter?

The word "risk" can have a variety of meanings, in the context of insurance.

- It can mean the two-sided risk that an outcome be greater or less than the estimated expected value of that outcome, as a result of variability and uncertainty. This is the meaning intended in this chapter. To emphasise this, this chapter sometimes refers to "risk (variability and uncertainty)".
- It can mean the one-sided risk that an outcome will be worse than its expected value.
- It can refer to the subject of the insurance.
- It can refer to the insured events.

In this chapter variability refers to the statistical variation inherent in the insurance process. This is amenable to statistical analysis of experience data. Given enough data, it can be quantified in terms of the variance and higher moments of a suitable probability distribution.

The concept of uncertainty is used here to depict a concept of risk that is broader than statistical variability. Some common aspects of uncertainty can include:

- Uncertainty in the estimates of expected value, variance and higher moments of a probability distribution. This uncertainty can be quantified as part of the statistical analysis.
- Uncertainty in the choice of probability distribution. Complex insurance processes seldom conform exactly to standard probability distributions. It may only be possible to partially quantify this uncertainty by considering alternate distributions.
- Uncertainty in the experience data will arise when the data contain more or fewer extreme events than normal. The selection of a suitable probability distribution may assist in quantifying this uncertainty.
- Uncertainty also arises because future circumstances can vary from the past. Environmental changes, technological changes and societal changes are all reasons why distributions based on past experience may need to be interpreted cautiously as guides to the future. Appropriate adjustments from past to future experience are a matter of judgment and introduce uncertainty into both the projected expected value and its variability.

How to appropriately reflect these sources of variability and uncertainty in the risk adjustment depends on the extent of the data and on the materiality of the potential impact on the result from the viewpoint of the reporting entity. In some cases, it may be appropriate to analyse the details extensively. Alternatively, it may be appropriate to undertake more limited analysis and to reflect other aspects of uncertainty based partly or wholly on judgment. Where data are limited, it may be necessary to rely very heavily on judgment. In assessing the extent of analysis which may be appropriate, judgment is needed as to the balance between the effort involved in undertaking deeper analysis versus whether the deeper analysis will result in a change in the estimates used to reflect risk and uncertainty that is both material and statistically meaningful.

4.7. What risks should be considered?

As discussed in question 4.3, paragraph B86 requires risk to be split between financial and non-financial risk and considered separately.

Paragraph B89 states that:

"The purpose of the risk adjustment for non-financial risk is to measure the effect of uncertainty in the cash flows that arise from insurance contracts, other than uncertainty arising from financial risk. Consequently, the risk adjustment for non-financial risk shall reflect all non-financial risks associated with the insurance contracts. It shall not reflect the risks that do not arise from the insurance contracts, such as general operational risk."

Furthermore, financial risk is defined in Appendix A as:

"*The risk of a possible change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract."*

Under these definitions, the risk adjustment for non-financial risk would include the uncertainty created by the following risks to estimates of the future cash flows. NB this list may not be exhaustive.

- Claim occurrence, amount, timing and development;
- Lapse, surrender, premium persistency and other policyholder actions;
- Expense risk associated with costs of servicing the contract;
- External developments and trends, to the extent that they affect insurance cash flows.
- Claim and expense inflation risk, excluding direct inflation index linked risk, since this is considered a financial risk.

For the risk adjustment associated with reinsurance held – see chapter 9.

The risk adjustment for non-financial risk would not include the uncertainty created by the following:

- Operational risk (i.e., risk not driven by the future cash flow items above). Examples include legislative risk, reputational risk, business interruption/the risk of cyber attack etc.;
- Asset-liability mismatch risk;
- Price or credit risk on underlying assets.

In some instances, there may be interactions between financial variables and non-financial variables that impact expected cash flows, making the distinction between financial risk and non-financial risk less clear. For instance, policyholder behaviour may be influenced by investment performance where there are linkages between investment returns and credited rates/contractual values. In this instance, the expected cash flows reflect this influence. The risk of policyholder behaviour being different than what is reflected in estimates of the expected cash flows would be considered non-financial risk. A further example is spread compression risk due to earned/credited rate differences where crediting rates are discretionary. The risk of this discretionary spread compression being different than what is reflected in the estimates of expected future cash flows would again be considered a non-financial risk.

4.8. What is risk aversion?

Risk aversion is an entity's reluctance to accept risk (variability and uncertainty), particularly as respects unfavourable outcomes. To overcome this aversion, entities typically expect compensation for bearing risk. The greater the risk aversion, the greater the expected compensation required. While it can be taken as a general truth that the expected compensation required increases as risk aversion increases, the relationship is not necessarily linear. For instance, the marginal compensation that an entity may require to accept marginal additional risk is likely to increase the closer the marginal additional risk brings an entity toward maximum levels of risk tolerance (i.e., risk aversion generally increases as one approaches the maximum levels of risk tolerance).

4.9. How can the actuary assess and express an entity's risk aversion?

The entity's board is usually responsible for its risk policy, including its policy on risk aversion. In some cases, the actuary may be able to draw on an explicit risk policy, such as that adopted by the entity's Board, which would typically be developed in consultation with the entity's Chief Risk Officer and/or enterprise risk committee.

In other cases, discussions with the entity's board and management may be appropriate. Topics for discussion that the actuary may find useful include:

- comparison with similar entities in the market;
- discussion of stress scenarios, both short and long term;
- the entity's underwriting and pricing policy and practices;
- the entity's approach to self-assessment of solvency risk with respect to capital needs and capital management; and

- the entity's reinsurance policy and practices.

4.10. What allowance should be made for risk diversification and what level of aggregation should be used?

The risk adjustment reflects in paragraph B88(a), inter alia, "*the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk*". Note the degree and structure of risk diversification are to be included within the entity's assessment of compensation.

Paragraph B88(a) uses the term *diversification*, suggesting a bottom-up approach to determining the required compensation, but does not preclude a top-down approach. If an entity uses a top-down approach, the entity can determine the total compensation that it requires for bearing non-financial risk and then allocate or apportion it. For example, the entity may allocate its risk compensation to whatever level of subdivision is required for financial reporting purposes. With this process, the extent of aggregation of the business risks for which the entity determines its total required compensation for bearing risk is the equivalent of the extent of aggregation of business over which diversification is reflected.

This aggregation encompasses all of the insurance contracts that the entity elects to include in setting its compensation for bearing risk. For example, an entity may elect to aggregate all of the insurance contracts that it writes.

A practical issue arises when evaluating the risk adjustment for the insurance written on a gross basis, i.e., without regard to reinsurance ceded. In principle, the compensation required for bearing risk would typically first consider the net risk for the entity, with due consideration given to the entity's use of reinsurance held as a financial resource available to the entity. Consequently, the entity's risk aversion will implicitly reflect its views as respects its net risk. To meet the requirement in IFRS 17 to estimate the risk adjustment associated with reinsurance held, it is necessary to reflect the differences in risk on a net basis versus on a gross basis, but maintain the entity's views regarding required compensation. The objective is to *"represent the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts"* as required by paragraph 64.

In some cases, the gross risk measurement might be approximately proportional to the net risk measurement and therefore the gross risk adjustment can be estimated by using a simple scaling factor applied to the net risk adjustment. In other cases, there may be quantitative and qualitative aspects of the risk and uncertainty such that the reinsurance held provides a very effective means of risk mitigation. For example, the value to the entity from the risk mitigation provided by its reinsurance held may be significantly greater than a simple scaling factor proportional to a selected risk measure. In such cases, it may be appropriate to consider other benchmarks or risk measures that are consistent with the entity's risk aversion (reflecting that its risk is mitigated via reinsurance) and also to consider the entity's estimate of its costs to retain, or replace, the reinsurance held.

If a bottom-up approach to risk adjustment is adopted, the total net required compensation for variability and uncertainty is an important check on the result of this process.

The risk adjustment may reflect the impact of diversification of non-financial risk across all of the insurance contracts that the entity selects. This may be the aggregation of all contracts to take account of all possible diversification benefits, or it may be at a lower level for sub-groups comprised of specific contracts or cohorts of business. The key consideration in making this choice is how the entity considers diversification in establishing the compensation it requires.

Where the entity consists of both a parent and subsidiaries, different perspectives have been put forward on how to reflect diversification in reporting at the group versus subsidiary level. One perspective is that the risk adjustment is set to be consistent across the group – that is, the risk adjustment at the subsidiary level should be the same as, and reflect the diversification benefits assumed at the group level. Another perspective is that the diversification benefits assumed could be different at the group versus subsidiary level if such an approach was consistent with the approach used by the subsidiary entity management to make its entity level decisions. Which of these perspectives should apply is a policy decision for the respective entities.

4.11. What allowance should be made for large and/or infrequent and/or atypical events?

The risk adjustment is intended to fully reflect all of the uncertainty and variability in insurance cash flows, incorporating allowance for all possible outcomes in proportion to their respective probabilities. This includes infrequent and atypical events in the tail of the distribution of outcomes. Where such tail events or combinations of events are not represented in the experience data, judgment may be needed as to how great an allowance is needed. Conversely, where such events are present, judgment may be needed as to whether they are over-represented.

In suitable cases, it may be possible to fit a probability distribution that makes due allowance for extremes, based on observed experience, but the suitability of the chosen probability distribution is also a matter of judgment. It is often helpful to model extreme outcomes separately from other events.

4.12. What allowance should be made for risk sharing mechanisms?

Risk sharing mechanisms may include:

- participation;
- investment linkage;
- deductibles and excesses;
- profit sharing;
- retrospective experience rating; and
- prospective experience rating schemes, such as no-claim discounts.

No allowance is likely to be made for prospective experience rating outside the contract boundary, as this does not relate to current contracts and is better regarded as part of the underwriting process for subsequent contracts.

Risk sharing arrangements can affect the contractual insurance cash flows between the insurer and the policyholder. Such cash flows may be contingent on insurance claims or other factors which may lessen the risk and variability of the entirety of the insurance cash flows. The risk adjustment will reflect all of these contract cash flows, with due consideration to the contingencies involved.

4.13. What is the compensation that the entity requires for bearing risk?

The compensation that the entity requires for bearing risk is a matter of judgment, which is ultimately exercised by the management of the entity and governed by the Board of the entity. In many cases, this will be informed by risk management expertise but, ultimately, the judgment is a Board responsibility, based on management (and possibly actuarial) advice.

Such judgments about compensation and risk are perhaps made regularly by entities in relation to the profit margin priced into their insurance policies. Examples of how such profit margins are expressed can be observed in a variety of ways, such as:

- an overall required profit margin on business written;
- a target rate of return or margin over risk-free on total assets, capital or equity;
- different profit margins on different classes of business; depending on perceived risk;
- a target probability which may be used for solvency assessment that losses will not exceed a given percentage of net assets; and
- an analysis of the net assets and margin over risk-free return required to support the total business, on a basis such as a target probability that those assets will prove adequate and a rate of return commensurate with that risk.

It is not, however, necessarily appropriate simply to apply the profit margin basis to estimate the risk adjustment. While a profit margin would seem to be a reasonable benchmark, in many cases there are considerations that go into selecting a profit margin that would not be consistent with the IFRS 17 measurement objectives for risk adjustments. For example, operational and asset-liability matching and investment risks that are not directly related to cash flows to the policyholder might be included in the profit margin but would not be considered in the risk adjustment. In addition, the criterion for risk adjustments is expressed as an amount which would make the entity indifferent between "risky" cash flows and fixed cash flows. Profit margins frequently reflect different objectives, such as desired market share and market competitiveness, policyholder dividend considerations, and pricing sensitivities, which may not be relevant considerations for the risk adjustment.

4.14. How should qualitative risk characteristics be reflected

Paragraph B89 requires that *"… the risk adjustment shall reflect all non-financial risks associated with the insurance contract …"* and paragraph B91(d) that "*the less that is known about the current estimate and its trend, the higher will be the risk adjustment …".* These provisions require that allowance for qualitative risk characteristics is to be incorporated into the risk adjustment. By their nature, incorporating such factors into the assessment of the overall level of risk requires judgment.

A first step is to assign a value to the level of risk and to assess the degree of correlation with measurable risks. In simple cases, it may be appropriate to assume that the risks are independent of one another, and can be approximated by combining the standard deviations as the square root of the sum of the squares. There are concerns that the analyses of the risk involved will provide an adequate basis for more sophisticated adjustments. However, if the qualitative risks are well enough understood, it may be possible to incorporate allowance for correlation and skewedness effects.

Actuaries are often confronted with situations for which information to develop assumptions for risk, including probability models, is limited. This is most frequently the case with new markets, new risks, long duration risks, and risks involving extreme or remote events, but unanticipated circumstances ("unknown unknowns") can arise almost anywhere.

There is no single appropriate approach to reflect qualitative considerations. However, IFRS 17 provides direction for each entity to choose one or more techniques that appropriately reflect the data, the information and the results from the models available, including the risk strategy of the management, and the extent of the uncertainty. It is important that the technique used appropriately captures the potential compensation for bearing the risk. (For example, a simple technique, such as adding a margin based on the estimated standard deviation, may not fully allow for the risk of very low frequency but high severity outcomes. A scenario testing approach might perform better, provided suitable extreme scenarios are included. Modelling using a suitably skewed probability distribution may be another approach.)

Both simple and complex techniques may be appropriate, depending on the nature of the uncertainty, the materiality of the uncertainty, and the structure of the underlying modelling available. For example, where uncertainty is material, and is characterised by a very low frequency and high severity risk profile and probability models are available, such a risk could be captured by introducing a state or regime switch into the model.

Since, by their nature, qualitative risks cannot be measured directly, the quantification effect is based largely on judgment. Where the impact of qualitative risks could be material, and since the responsibility for the risk adjustment lies with the entity, it may be desirable for the actuary to discuss these risks with the entity.

Qualitative risks are seldom symmetrical. Because of this, it may be appropriate to make an adjustment, based on judgment, to the risk adjustment solely on the basis of knowledge of the risks involved and any observed experience that could be relevant.

4.15. What disclosures and explanations are required?

Paragraph 93 states that "*The objective of the disclosure requirements is for an entity to disclose information in the notes that, together with the information provided in the statement of financial position, statement(s) of financial performance and statement of cash flows, gives a basis for users of financial statements to assess the effect that contracts within the scope of IFRS 17 have on the entity's financial position, financial performance and cash flows. …".*

The disclosures required are set out in paragraphs 93-96. Paragraphs 97-132 set out the required "explanation of recognised amounts".

For the most part, these disclosures relate to amounts that are inclusive of risk adjustments and are discussed in other chapters. The specific requirements in respect of risk adjustments are:

- "*For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall also disclose reconciliations from the opening to the closing balances separately for each of: … (b) the risk adjustment for non-financial risk…"* [Paragraph 101].
- *"An entity shall disclose the significant judgements and changes in judgements … (c)(ii) to determine the risk adjustment for non-financial risk …"* [Paragraph 117]
- *"An entity shall disclose the confidence level used to determine the risk adjustment for non-financial risk. If the entity uses a technique other than the confidence level technique for determining the risk adjustment for non-financial risk, it shall disclose the technique used and the confidence level corresponding to the results of that technique."* [Paragraph 119].

Where the PAA has been applied, the applicable paragraphs requiring explanation of recognized amounts are 98 – 100 and 102 – 105. Of these, risk adjustment for non-financial risk is mentioned in each of paragraphs 100 and 104.

4.16. What explanations and disclosures might be included in the actuary's communications?

While there is no stated requirement in IFRS 17 that the risk adjustment will be determined by an actuary, the work products and input of actuaries are very likely to be relied upon to develop, review and maintain the risk adjustment values. An important objective of the actuary's communications is to assist the entity in developing its IFRS 17 disclosures and to enable the Board and management to better understand the way in which the actuary has undertaken his or her work. Key elements of these communications, relative to risk adjustments, may include a discussion on:

- the background to the disclosures required;
- how the compensation the entity requires for bearing risk has been quantified;
- how the entity's risk aversion has been assessed and incorporated in considering the entity's required compensation for bearing risk;

- how risk has been identified, quantified and translated into a risk adjustment;
- how qualitative and unknown risks have been allowed for, including their relative importance, within the risk adjustment;
- the impact of reinsurance and other risk transfer or mitigation considerations;
- any uncertainty in relation to recoverability of reinsured amounts;
- how risk diversification has been considered, within and across product lines, geographic divisions, across entities within a group, etc.; and
- the insurer's net risk profile and how this is appropriately reflected in the difference between the gross and reinsurance risk adjustments.

4.17. What are appropriate methods to allocate risk adjustments calculated at a more aggregated level to a more granular level?

IFRS 17 does not require the risk adjustment to be directly determined at any specific level of granularity; however, to obtain appropriate fulfillment cash flows for each group of contracts the risk adjustment needs to be allocated at least to the group of contracts level for various purposes (e.g., CSM, liability for onerous contracts).

If the risk adjustment is initially calculated at a more aggregated level, any reasonable method that will lead to the same total risk adjustment, were the risk adjustment directly determined at the lower level of aggregation, is appropriate to more finely allocate the risk adjustment. Such methods reflect the key drivers of the risk adjustment calculation. For example, if the risk adjustment reflects components separately determined for insurance risk, policyholder behavior risk and expense risk, the allocation methodology would use risk drivers that appropriately attribute the impact of each of these risks to the lower levels of aggregation.

Consideration could also be given to running more complex models at a higher level of aggregation (and perhaps less frequently) and then simplified into factor matrices to use at a more granular level in the valuation.

4.18. What are appropriate ways to estimate confidence levels for disclosure when not directly available from the risk adjustment calculations?

In order to determine confidence levels, it is necessary to be able to locate the value of the fulfillment cash flow of a collection of insurance contracts on the probability distribution of the present value of the cashflows for the contracts. If that probability distribution is not explicitly derived as part of the valuation process, some method or model might be needed to estimate the percentiles of that combined portfolio distribution at the amount that reflects the risk adjustment. The extent of the analysis needed for such estimation is likely to require judgment.

For large collections of insurance contracts, there may be sufficient evidence about the tail of the probability distribution.

In other cases, the form of the probability distribution might be selected based on judgment and the parameters for that probability distribution might be selected by judgment based on what is considered appropriate for the purpose of this disclosure.

NB the sensitivity of the resulting confidence level to the chosen probability distribution increases as the confidence level increases.

The relevant part of the probability distribution may be defined in terms or two of more quantiles that straddle the fulfillment cash flow based on evidence and judgments which would explain the values chosen for those quantiles.

4.19. What other considerations are relevant when estimating and communicating confidence levels?

Different actuaries providing advice on confidence levels for similar reserves for similar risks may reach very different conclusions depending on the assumptions and methodology followed and on the judgment applied.

External users are likely to place significant importance on the confidence level disclosure and compare entities to their peers. As a result, this is an area where the actuary can help management understand and communicate the issues and challenges related to this important estimate and the appropriate explanation associated with this disclosure.

Estimating the confidence level disclosure will depend on how well the aggregate probability distribution is understood. When the moments of the probability distribution can be estimated, the relative uncertainty related to such estimates increases with the order of the moment estimated. Consequently, there are risks associated with interpreting the confidence level disclosure with a false sense of precision in such estimates. This risk can be mitigated by providing a better understanding around the qualitative considerations involving the level of subjectivity and judgment involved in estimating the confidence level.

In determining the confidence level using a particular technical method there are additional considerations related to how well the method reflects the full range of outcomes, and whether the method used is stable over time, is fairly representative of ongoing conditions, and can be replicated.

As the degree of uncertainty (in the confidence level estimate) increases, the need for judgment increases and, with it, the need to better understand and communicate, to the entity, both the uncertainty and the way in which judgment has been exercised.

4.20. Should confidence level disclosure be done gross or net of reinsurance?

IFRS 17 does not specify whether the disclosure of a confidence level is intended to be on a gross or net-of-reinsurance basis. The entity's reported risk adjustment is required on a gross level as a liability. If the entity has reinsurance held, the entity also separately reports the risk adjustment associated with reinsurance held. The entity's net risk adjustment is not reported as a separate item. However, the estimation of separate confidence levels for disclosure that correspond to the gross risk adjustment (liability) and

the reinsurance held risk adjustment (asset) may present significant technical issues and may not provide the relevant information intended.

The level of disclosure is likely to be determined by market practice.

4.21. What is the appropriate granularity for disclosure of confidence levels?

Paragraph 119 requires disclosure of the confidence level associated with the risk adjustment. The standard only requires one confidence level disclosure for the reporting entity, however, it is not prohibited to provide additional disclosure at a more granular level.

The overall disclosure policy of the reporting entity is relevant to determining the approach to confidence level disclosure.

4.22. To what extent is it appropriate to use analyses and measurements made for other purposes, such as pricing, embedded value, regulatory reporting or capital modelling?

IFRS 17 does not mandate particular technique(s) to determine risk adjustments, nor does it specifically limit the techniques that may be used, or provide examples of appropriate techniques.

The primary requirement in the application guidance is that "The risk adjustment for non-financial risk for insurance contracts measures the compensation that the entity would require to make the entity indifferent between:

(a) fulfilling a liability that has a range of possible outcomes arising from non-financial risk; and

(b) fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts." (B87)

While it may often be desirable to make use of analyses conducted for other purposes, the conclusions drawn from such analyses may not be transferrable. Such conclusions depend on the perspective and purpose for which they are required. Risk adjustments are set in a fulfilment perspective in comparison to expected values (e.g., central estimates or best estimates) that are required to represent unbiased mean values. This is not necessarily true of measurements set in other contexts. The underlying rationales of market, entry and exit values and of pricing are clearly different. This means that pricing and exit value assessments of the liability may not be appropriate ways to calibrate risk adjustments.

Internal capital models that are developed within regulatory frameworks (and/or for pricing purposes) may provide a good reference for how the entity views and assesses risk. Therefore, the techniques used to measure risk and develop risk adjustments for IFRS 17 can be compared against the techniques and measurements used under such other frameworks as a means to assess for reasonableness, and to potentially leverage the underlying analyses for both purposes. However, the resulting risk adjustments would be determined based solely on the IFRS 17 criteria.

Regulatory solvency capital adequacy models that align well with how an entity views and assesses risk may, similarly, be potentially leveraged in the development of appropriate IFRS 17 techniques to measure and assess risk. However, IFRS principles for the valuation of insurance contract liabilities are not based on the solvency requirements of an insurer, so they can only be leveraged to the extent they generally reflect how the entity views and assesses risk. Having said this, regulatory capital adequacy requirements do place constraints on the entity, and are likely to influence its views.

A further complication is that both internal and regulatory capital requirements are there to cover all of the risks faced by the entity, while the risk adjustment in the fulfilment cash flows excludes risks outside the insurance contract (such as operational, asset and asset-liability mismatch risks) and risks reflected through the use of market consistent inputs (see question 6.7). Even where regulatory minimum capital is built up in an additive structure, it does not necessarily follow that the insurance components of such a structure fully represent the insurance risks, since the underlying relationships are unlikely to be fully additive.

4.23. To what extent can different approaches be used to determine the risk adjustment within the same valuation?

There is no requirement to use a single model or approach for all the business or all the risks. An entity may use a mix or blend of methods to set risk adjustments across different businesses provided such an approach makes appropriate allowance for diversification and is done in a way that can be reasonably discussed and explained to external auditors and is relevant to users (which is likely the biggest hurdle to a mixed model approach).

Consideration could be given to running more complex models at a higher level of aggregation (and perhaps less frequently) and then simplified into factor matrixes to use at a more granular level in the valuation.

4.24. What time horizon is used in measuring the risk adjustment?

The "compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk" is generally understood to mean the compensation required for bearing the non-financial risks associated with all cash flows within the contract boundary for the duration of the contract boundary.

4.25. Where the measurement of the risk adjustment utilises a separate capital measure, what time horizon is used for the capital measure?

The time horizon used for a capital measure may be different than the time horizon used in measuring the risk adjustment, without causing inconsistencies. For example, a capital measure may use a short time horizon (e.g., 1-year, with terminal provision). The measurement of risk adjustment may use, as input, a series of capital measures that each use a 1-year time horizon. For example, in the traditional "cost of capital" approach, the capital measure may be based on a short time horizon (using a 1-year horizon) for capital at a given point in time, then such capital measures would be projected for future time

points over the contract boundary, and then each future point estimate would be multiplied by a cost of capital rate, and then discounted back to the measurement date.

Chapter 5 – Level of Aggregation

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

5.A. What does this chapter address?

This chapter considers the level of aggregation/unit of account that needs to be considered when valuing insurance contracts within the scope of IFRS 17.

5.B. Which sections of IFRS 17 address this topic?

Paragraphs 14-24 provide guidance on this topic.

BC115-139 also provide background on the subject.

5.C. What other IAA documents are relevant to this topic?

None

Overview

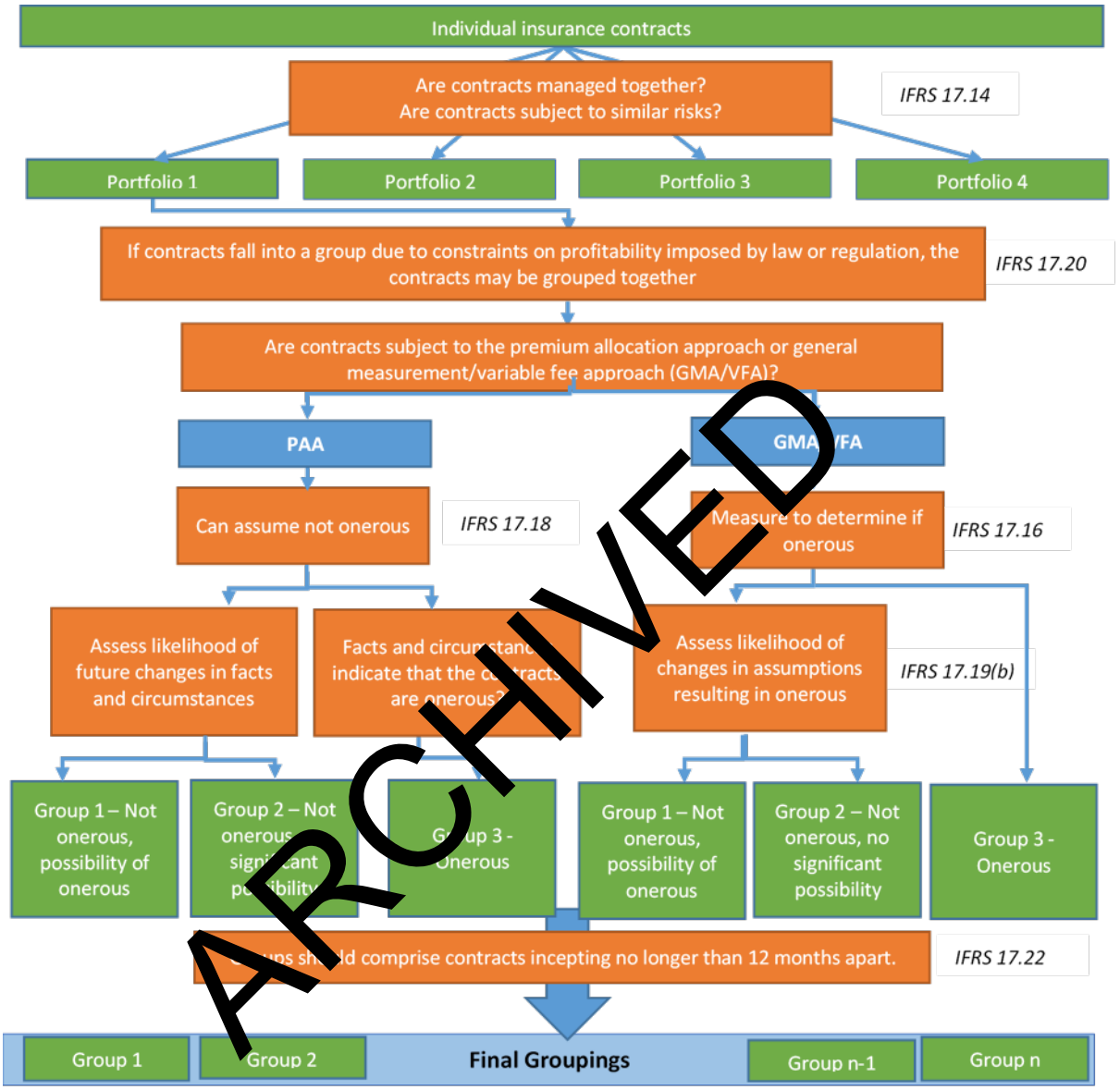
5.1. What is the purpose of aggregation?

IFRS 17 deals purely with insurance contracts and investment contracts with discretionary participating features (DPF). In most instances it is likely to be impractical, however, for an entity to measure all insurance contracts at a contract unit level. Consequently, all insurance contracts in the scope of IFRS 17 are aggregated into portfolios and groups within portfolios on initial recognition and not reassessed subsequently (paragraph 24). In doing so, the IASB intends to limit the obscuring of information that would occur by offsetting onerous contracts in one group with profitable contracts in another (paragraph BC119).

5.2. What are the levels of aggregation?

In determining the level of aggregation, an entity identifies portfolios of insurance contracts. Each portfolio is divided into groups, which distinguish onerousness, and the entity aggregates individual contracts into these groupings. An entity cannot include contracts issued more than one year apart into the same group (paragraphs 16, 17 and 22). A summary of the levels of aggregation is presented in figure 5.1 below.

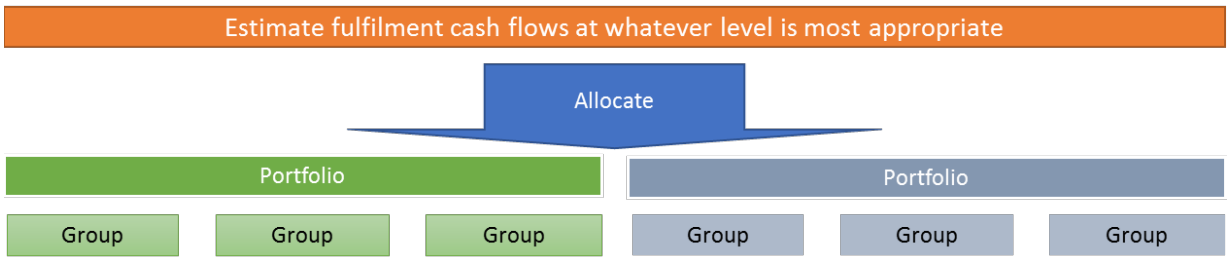
Figure 5.1: Level of Aggregation



5.3. At what level of aggregation are fulfilment cash flows required to be estimated?

When measuring groups of insurance contracts, an entity may estimate the expected present value of future cashflows, discount rates and the risk adjustment for non-financial risk at a higher (or lower) 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 by allocating such estimates to groups of contracts (paragraph 24). This is depicted in figure 5.2 below.

Figure 5.2: Allocation of Fulfilment Cash Flows



5.4. Why is the level of aggregation important?

The level of aggregation determines the recognition and measurement requirements of IFRS 17 (paragraph 24). Groups will need to be tracked and measured throughout the lifetime of the contracts.

For many entities, the grouping exercise could have significant practical and operational issues in respect of the entity's administration, valuation and accounting systems.

Identification of Portfolios

5.5. What is a portfolio of insurance contracts?

A portfolio of insurance contracts is defined in paragraph 14 as *"A portfolio comprises contracts subject to similar risks and managed together"*. Each portfolio forms a partition of the total insurance business of the reporting entity. Accordingly, each contract is at inception allocated to one portfolio, it may, under certain circumstances, be apportioned across multiple portfolios if the contract covers different types of risks and these risks are unbundled.

5.6. What does subject to similar risks mean?

No clear definition of similar risks is given in the standard. Paragraph 14 states that *contracts within a product line would be expected to have similar risks*, and consequently could be considered as a portfolio if they are managed together.

5.7. What does managed together mean?

Again, there is no clear definition in the standard for this term. Hence judgment is required on what constitutes managed together.

From a practical perspective, the considerations relating to subject to similar risks noted above will require a level of granularity in assignment of portfolios that, in many cases, could result in portfolios that are naturally managed together.

It is expected that the determination of the portfolio level will vary between entities, due to different sizes and complexity of entities, as well as the different ways in which business is managed. A practical approach to determining the portfolios for an entity might rely on the internal management reporting systems.

An entity might change how it manages its business over time and, as a result, the number of portfolios might change over time. This is an anticipated response under the standard, although it does not necessarily affect the number of groups as historical groups do not change and groups are a sub-set of the portfolios.

5.8. Can multi-peril (or multi-benefit) products be aggregated in the same portfolio?

Peril aggregation is a common feature of general insurance products. Benefit combination is also a common feature of life insurance products. If the contracts are subject to similar risks and managed together, then it could be concluded that multi-perils (or multi-benefit) contracts can be aggregated into portfolios.

Also, relevant may be the following references and TRG papers relating to the separation and combination of insurance contracts:

- Paper AP01 for the February 18, 2018 TRG meeting and discussion thereof which provide guidance on when it may be appropriate to separate components of insurance contracts.
- Paragraph 9 and paper AP01 for the May 18, 2018 TRG meeting and subsequent discussion which provide guidance on the combination of insurance contracts, and

Additionally:

- BC119 states that aggregation set by regulators serves a different purpose than aggregation for financial reporting; and
- peril type aggregation used for actuarial modelling of reserving would not necessarily be a suitable basis for aggregation given its alignment with solvency and valuation requirements.

This supports the bunching of perils within portfolios and groups from a practical standpoint, however if the contracts cover multiple perils or benefits then separation of these components may first be required. The attribution of premium income to multiple peril groupings could be challenging, particularly if those perils were not priced explicitly within an additive pricing structure. This complexity might lead to potential inaccuracies in financial reporting, notably the consideration of whether the contract groups are onerous. Materiality of the potential inaccuracies in financial reporting is a consideration for actuaries.

Although not explicitly prohibited or prescribed in IFRS 17, it is unlikely that individual multi-peril contracts would be split into separate portfolios for the purposes of measurement under IFRS 17, purely due to their multi-peril nature. This is discussed in paper AP01 for the February 18, 2018 TRG meeting where the intention is clearly stated that a contract with legal form of a single contract would generally be considered a single contract in substance. There might be circumstances where it is not the case. The TRG observed that:

"..overriding the contract unit of account presumption by separating insurance components of a single insurance contract involves significant judgement and careful

consideration of all relevant facts and circumstances. It is not an accounting policy choice." (TRG Summary Feb 18 paragraph 7(b)(ii)).

5.9. Can separate types of risk be split out from a contract?

Following deliberations at the February 2018 and May 2018 TRG meetings it is generally agreed that the lowest unit of account is the contract. There is a presumption that a contract with the legal form of a single contract would generally be considered as a single contract in substance.

However, there might be certain facts and circumstances where legal form does not reflect the substance. For example, where transactions that are typically written as separate contracts have been bundled together as one legal contract for customer convenience or where a set or series of insurance contracts with the same or a related counterparty can be treated as a single contract. This will require careful consideration of the level of interdependencies between the different components such as shared deductibles and limits and where the lapse or termination of one component results in the termination of the whole contract.

5.10. When is a contract allocated to a portfolio of insurance contracts?

Practically, at the same time as groups are defined (see question 5.13).

5.11. Are portfolios of insurance contracts fixed for all time?

Since the definition of a portfolio refers to a purely business criterion, managed together may change over time. IFRS 17 requires a current assessment for any new business written, which means that the portfolios for an entity might change over time for new business or renewal written.

5.12. Is the entity free to refine the partition of the business in force?

No. A contract is required to be assigned to a group (which is a subset of portfolio) at initial recognition of the contract.

Organisational changes in the way contracts are managed together may require further portfolios to be created for new business and/or renewed business (where this is accounted for as a new contract), but does not affect the allocation of already existing contracts which remain in their assigned groups.

Partitioning into Groups

5.13. What is a group of insurance contracts?

A group of insurance contracts is a further partition of a portfolio according to when the contract is written and expected profitability (paragraph 16 and Appendix A). Hence a "group" is a set of new business or renewal contracts, which are issued no more than 12 months apart, to be measured together. It is a sub-set of a "portfolio". Each group is sometimes referred to as a 'unit of account' (though this term is not used in IFRS 17).

5.14. When is an issued contract grouped?

Paragraph 25 specifies that a group of insurance contracts is recognised at the earlier of the date when insurance coverage commences or the date the initial premium becomes due or if the group of contracts is onerous, when the group becomes onerous. New contracts are added to the group as they are written, subject to them being issued no more than a year apart (see below).

An entity shall establish the group at initial recognition and shall not reassess the composition of the groups subsequently (paragraph 24), except in the cases of a specified contract modification (paragraphs 72 and 76). This applies even if contracts within a group, or the group as a whole, are subsequently found to be onerous when they were not at initial recognition.

Question 5.11 above refers to portfolios changing over time if the business manages its insurance contracts in different ways.

Significant contract modifications are covered in more detail within Chapter 14.

5.15. What is the meaning of the limitation to contracts being issued no more than one year apart at inception?

Paragraph 25 specifies the circumstances in which a group of insurance contracts is first recognised. The issue date of an insurance contract is the earlier of the beginning of the coverage period and the date the premium becomes due. An entity shall not include contracts issued more than one year apart in the same group (paragraph 22). This refers to the date of issue of the contract being recognised under IFRS 17, which is not necessarily the same as date the contract was initially written, as due to the application of contract boundary, the renewal of a long-term contract may be treated as creating a new contract under IFRS 17.

Contracts that legally bind the insurer for only a short period (e.g., most general insurance contracts) may get reissued at the renewal date. This will be a new contract under the standard and hence the renewal date forms the issue date.

A complication for general insurers is that cohorts based on accident year may not necessarily correspond with contracts issued less than one year apart.

There is no restriction against containing shorter issue periods than this and this requirement does not require that the one-year period coincides with accounting periods or calendar years.

For contracts that bind the insurer for longer periods (e.g., most life insurance contracts) it is more complex. These contracts might be guaranteed renewable and the contract legally continues subject to payment of the renewal premium due. However, although the contract legally continues, IFRS 17 may treat the renewal date as the contract boundary and the renewal as creating a new "contract" for IFRS 17 purposes separate from the exiting contract. In which case, the underlying policy contract may be treated as multiple "contracts" for IFRS 17 purposes over its life (paragraph 35). In this case "issue" date

refers not to the original date of commencement but to date of the renewal that incepted the contract under IFRS 17.

5.16. How is a contract allocated to a group?

Under the GMA and VFA, each contract to be grouped is assigned to one of at least three categories:

a. Onerous (loss-making) at initial recognition;

b. no significant possibility of becoming onerous at initial recognition; or

c. any remaining contracts in the portfolio into one or more groups.

In practice, individual contract assignment might be possible, but insurers may not attempt to assess the risk exposure in full detail and will therefore choose a certain level of differentiation of contracts corresponding with such elements, such as differentiation of risk and pricing. *Reasonable and supportable information* is the terminology used in the standard. Paragraphs 17 and BC 129 highlight the IASB's intention that the objective of assigning contracts to the three categories mentioned above can be achieved by assessing a set of contracts, if the entity can conclude, using reasonable and supportable information, that the contracts in the set will all be in the same group.

Under the PAA, the entity assumes contracts in the portfolio are not onerous at initial recognition unless facts and circumstances indicate otherwise (paragraph 18).

5.17. How might grouping be different for contracts with participation features?

When considering how to apply the grouping for contracts with participation features, it is important to consider how areas in respect of mutualisation between contracts and the impact of participation might affect the allocation to groups. This is the case in respect of both considering whether contracts are subject to similar risks (portfolio allocation) and the split in respect of profitability.

IFRS 17 has paragraphs specifically on mutualisation (paragraphs B68-B71 and B103). These allow that, in calculating the value of expected cash flows, an allowance can be made for cash flows originating from contracts in other groups, not just cash flows arising solely from contracts in that group. Similarly, when doing this calculation, cash flows implicitly transferred to other groups are to be excluded. Note that this ability assumes that profit from the donor group has not already been released.

Because of the allowance for cash flows to be transferred between groups, what would otherwise be an onerous group will potentially be profitable. Similarly, if a group is potentially about to become onerous, then a transfer from a profitable group is expected to prevent that.

One might even argue that there is no point in sub-dividing groups by year of issue, because cash flows from a more profitable cohort could be transferred to a less profitable cohort. The ability to transfer between cohorts means that the profitability for business written in separate periods should be less differentiated. There may bring particular

operational challenges when determining the groups in respect of businesses where new policies share in profits generated by the existing book and vice versa.

However, the IASB has stipulated that groups be differentiated by not containing contracts issued more than one year apart. This is because the IASB expects that profitability would vary over time, and at the extreme one cohort might be onerous while another is profitable. The IASB did not want this information obscured by offsetting onerous contracts in one group with profitable contracts in another (see paragraph BC119 and the last two sentences of paragraph BC136).

The IASB therefore, still felt that subdivision by year of issue was appropriate, even where there were transfers of cash flows between groups (see paragraph BC138). The requirement in paragraph 22 is that an entity shall not include contracts issued more than one year apart.

Paragraph BC138 notes that the amounts to be reported for each group are specified, but it is not necessary to calculate amounts at a group level, so calculation could presumably be undertaken at a higher level and the results then allocated to each group – this is important in the context of mutualisation, as IFRS 17 assumes that the amount of any transfers will be specifically known, whereas the actual quantification is likely to vary over time as facts and circumstances change.

5.18. How might the pool of underlying items affect portfolios?

As explained in 5.5 'portfolios' are defined as contracts subject to similar risks and managed together. It will be up to the entity to determine how risks and management are affected by the pool of underlying items.

For example, it might be determined that contracts are subject to different risks, and hence be in different portfolios, notwithstanding that they participate in the same pool of underlying items. Conversely, it may be that a single portfolio covers contracts that participate in multiple pools of underlying items.

5.19. How are contracts added to an existing group?

The establishment of a group can be a process that spans up to a year. The original classification of the group determines the allocation of new contracts during that period. If the expected profitability of an open group changes during that period, it might be appropriate to close the open group and open a new one if new contracts are added that differ in profitability level.

5.20. What is reasonable and supportable information when determining whether a set of contracts can be considered as a group?

Paragraph 17 indicates consideration should be given to the availability of reasonable and supportable information to justify the grouping of contracts. In the absence of such information, an entity shall determine the group to which the contracts belong by considering individual contracts.

Reasonable and supportable information could be considered to be readily available internal management and reporting information. Examples might include policy disclosure statements, valuation reports, pricing reports or other key profitability metrics presented to senior management or the Board of Directors.

Where the entity can reasonably undertake a measurement approach at an individual contract level, this would also enable a grouping assessment to be made.

5.21. What is the difference between no significant possibility of becoming onerous and other non-onerous contracts?

Paragraph BC130 discusses the intent of this separation in a limited manner.

Internal guidance might be created by an entity that specifies the details of the metrics that are required to determine whether contracts fall into the no significant possibility group. The approach is likely to vary across entities, given the judgmental nature of this determination.

5.22. Does the liability for incurred claims need to be separated or identified by group (portfolio, underwriting year, level of onerousness)?

Paragraph 40 stipulates that:

> *The carrying amount of a group of insurance contracts at the end of each reporting period shall be the sum of:*
>
> *(a) the liability for remaining coverage […] and*
>
> *(b) the liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date…*

It is also noted that each group is a unit of account.

In practice though, it is anticipated that the outstanding claim valuation could be carried out at a different level of aggregation than the defined groups, then allocated down or aggregated up to the adopted unit of accounts. Paragraphs 24, 33 and 40 make it clear that allocating the fulfilment cash flows to groups from a higher level of aggregation, is quite acceptable for any type of valuation activity.

5.23. What happens if the interim or financial year end cut short the grouping year? Is the reported weighted discount rate restated allowing for the remaining months?

An entity may add contracts to a group, as long as they are not issued more than one year apart from any other contracts in the group. As contracts are added to a group, this may result in a change in the weighted-average discount rates at the date of initial recognition for the group. As indicated in paragraph 28, these revised discount rates are applied from the start of the reporting period in which the new contracts are added to the group. See chapter 3, (How is the average locked-in curve determined for a group of contracts?) where various options are discussed to calculate the weighted average discount rate.

Careful consideration will be needed in respect of this paragraph when changing the weighted discount rate.

Further Disaggregation

5.24. Is it appropriate to determine groups on a more granular level than prescribed?

There are no constraints on refinement of groups beyond the minimum level prescribed (paragraph 21).

5.25. Can a group comprise of a single contract?

Yes, a group can comprise a single contract if that is the result of the grouping exercise (paragraph 23).

Regulatory Constraints

5.26. How does community rating and legislated limitations on use of underwriting variables impact grouping?

Where law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics then those characteristics can be ignored for allocating policies between groups. Therefore, if a particular characteristic that is restricted would result in policies being split between onerous and other allocations, this characteristic can be ignored. The exemption cannot be applied by analogy to other items (paragraph 20).

An example would be the gender-neutral pricing regulations in Europe, where because of the legislation males and females would be included in the same group even if there is statistical evidence of differences in risk. Another example is age, gender and pre-existing conditions in health insurance which are restricted from being used for pricing by legislation and would usually result in some policies being onerous based on current prices. In these circumstances policies that would or wouldn't be onerous due to these characteristics may be grouped together.

5.27. How should one consider regulatory pricing constraints?

The exemption in paragraph 20 applies only when 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 categorisation would therefore be applied either to the portfolio as a whole, or groupings excluding the regulatory or legal constraints. Care needs to be taken in determining the extent of the legal or regulatory constraint, and delineating it from business decisions (see e.g., paragraphs BC133-BC134).

Other Questions

5.28. How are reinsurance contracts aggregated?

The entity accounts for reinsurance contracts held separately from the underlying insurance contracts to which it relates. Entities apply the aggregation requirements in paragraph 61 to *"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".

Further discussion is presented in chapter 9 – Reinsurance.

5.29. What mismatches might arise?

The principle of IFRS 17 (paragraphs B66(b) and explained in BC298) is to separate the underlying gross liabilities from any associated reinsurance held. This means, for example, a contract which is onerous at inception on a gross basis would still be considered onerous and accounted for as such even where 100% of this risk is ceded to another party on an original terms coinsurance basis. In this example, the reinsurance held asset would not offset the impairment on the gross liability (i.e., asymmetric accounting, with the practical consequence of a day one loss from the gross liability impairment offset by income from the reinsurance ceded asset over the lifetime of the reinsurance contract).

The VFA cannot be applied to reinsurance held business, even if it is applied to the underlying insurance contracts. See chapter 9.

5.30. What are the implications of aggregation for presentation and disclosure?

An entity is required to present income or expenses from reinsurance contracts held separately from the expenses or income from underlying insurance contracts issued (paragraph 82).

Paragraph 38 requires the separate disclosure of the groups of contracts that are issued as assets and that are issued as liabilities. Groups of contracts in a liability position are those where the total insurance contract liability is positive. Groups of contracts in an asset position are those where the total insurance contract liability is negative.

Further discussion is presented in chapter 15.

5.31. How are business combinations and portfolio transfers treated?

On acquisition of a portfolio or set of contracts paragraph B93 applies. The acquirer reassesses the groups using paragraphs 14-24 to identify the groups as if they had been issued on the acquisition date. As the contracts would all have the same acquisition date the requirement around issued less than 12 months apart would no longer be applicable. Illustrative example 14 from IFRS 17 Illustrative Examples shows the accounting for this.

A business combination will also require additional considerations in respect of the portfolios and groups to which these contracts belong. The portfolios that were split into groups based on profitability may have changed from the original entity.

When purchasing an entity, groups are assessed at the date of the business combination date (paragraph B93). However, for the original entity the assessments would remain as previously assessed and based on the original application of paragraphs 14 to 24. This will lead to different treatments between the entity and its parent group accounts with non-alignment of the aggregations.

For intra group transfers of business, if it is assessed as a transfer of business which is not an IFRS 3 business combination paragraph B93 does not apply. (This was agreed at the June 2018 IASB meeting.)

Further discussion is presented in chapter 11.

5.32. What exceptions are allowed at transition?

This will depend on which transition method is being used to measure the group of insurance contracts. Regardless of the transition method, once adopted, groups are fixed at transition and contracts remain in the same group thereafter.

If a full retrospective approach is adopted, as per paragraph C3, there are no exceptions and business written up to transition is grouped applying IFRS 17 retrospectively as if it had always applied.

If the modified retrospective approach is applied, as per paragraphs C8 and C9, the identification of groups of insurance contracts can be carried out with the information available at the transition date. Also, groups can include contracts issued more than one year apart. However, this modification can only be used to the extent that an entity does not have reasonable and supportable information to apply a retrospective approach. If the entity does have the information to make the split by portfolio/group for a particular group this information should be used.

If a fair value approach is adopted, as per paragraph C23, it is permitted (but not required) to include in a group contracts issued more than one year apart. You can only divide into groups issued within a year or less, where you have reasonable and supportable information to make the division. The difference here is that whereas for the other two approaches you must make the divisions if you have the information to do so, for the fair value approach you are allowed (but not required) to make the divisions if you have the information to do so.

Further discussion is presented in chapter 12.

Chapter 6 – Contractual Service Margin and Loss Component

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

6.A. What does this chapter address?

This chapter provides information about the contractual service margin (CSM) – what it is, how it should be determined and how it might change because of a range of factors – and the treatment of the loss component of "onerous contracts".

6.B. Which sections of IFRS 17 address this topic?

Paragraphs 38-39, 43-46, 47-52 and B96-B100 provide guidance on this topic.

BC218-BC226, BC228-BC237, BC270-BC275 and BC277-BC287 also provide background on the subject.

6.C. What other IAA documents are relevant to this topic?

None

Overview

6.1. What is the purpose of the CSM?

The CSM is defined in Appendix A of IFRS 17 and represents the unearned profit the insurance entity will recognise as it provides services under the insurance contracts in a group. The CSM is a component of the insurance contract liability for a group of contracts.

It is measured at initial recognition for a group of contracts as the excess (if any) of the expected present value of cash inflows over cash outflows, within the boundary of the contract (including acquisition costs), after adjustment for non-financial risk.

If there is no excess of inflows over outflows at inception, the contract is onerous, no CSM is established and a loss component is calculated at the time of initial recognition.

Thereafter the CSM is rolled forward with interest accrual, adjustments for some experience items, cash flow estimates and risk. The loss component is allocated on a systematic basis in accordance with paragraph 50. The CSM is then released based on coverage units representing the service provided in the period and that now expected to be provided in the future.

This means that while the initial determination of the CSM for the group is a prospective calculation, thereafter it is primarily a retrospective calculation or roll forward.

The CSM reflects the IASB's view that profit on insurance contracts should only be recognised as service is provided, consistent with IFRS 15 (see paragraphs IN7 and BC18) and not on day of policy sale.

Measurement on Initial Recognition

6.2. How is the CSM determined at initial recognition?

The CSM for a group of insurance contracts is established at initial recognition to offset any profit that may arise from just considering the fulfilment cashflows. The fulfilment cash flows include expected future cash outflows and inflows as well as the risk adjustment for non-financial risk and any pre-coverage cash flows. Therefore, at initial recognition, the CSM considers all contractual cash flows (future and past) within the contract boundary.

In the case of a profitable contract, the outcome of measuring all cash flows should be negative (total cash outflows minus total cash inflows). This asset is eliminated at contract inception by the creation of the CSM as an additional component of the liability of the group of insurance contracts. However, pre-coverage cash flows can impact the amount actually recognised on the balance sheet (see question 6.3). The outcome in the case of an unprofitable contract is discussed in question 6.4.

Other than in the case of reinsurance the CSM is subject to a minimum of zero.

There is no difference in the calculation of the CSM at inception for groups of insurance contracts without direct participation features and those with direct participation features.

The CSM at initial recognition and subsequently is determined at the level of the group of insurance contracts (i.e., the CSM does not need to be calculated at individual contract level).

6.3. What are pre-coverage cash flows?

In this chapter, pre-coverage cash flows include contractual cash flows relating to the contract that were paid/received by the insurer before the recognition date of the contract. The recognition date determines which cash flows are "pre-coverage" and which are not. Examples of pre-coverage cash flows may include:

Premiums under the contract;

Commissions spent due to contractual obligations with an intermediary in response to writing the contract; and

Cost arising during the application and underwriting process (underwriting cost) and issuance cost.

Pre-coverage cash flows include any insurance acquisition cash flows for which an asset or liability is held prior to the recognition of the group that gave rise to them (see paragraphs 27 and 38). Further, this includes both cash flows that are directly or indirectly allocated to a contract e.g., acquisition cost spent without success, provided they are directly attributable at a portfolio level.

Paragraph 25 states that the recognition date of the contract is the earliest of the following:

the beginning of the coverage period of the group of contracts;

the date when the first payment from a policyholder in the group becomes due; and

for a group of onerous contracts, when the group becomes onerous.

6.4. Can the CSM be negative at initial recognition?

Except in the case of reinsurance (see chapter 9 on reinsurance), the CSM cannot be negative and, when the calculation indicates a negative value, is instead set to zero. This results in a loss being reported equal to the amount by which the CSM otherwise would have been negative.

The negative balance is referred to as the loss component (see questions 6.26 – 6.29 on onerous contracts).

Subsequent Measurement: Contracts without Direct Participation Features

6.5. What changes are recognised in the CSM for contracts without direct participating features?

Paragraph 44 outlines how the CSM for a group of insurance contracts without direct participating features moves over time. It is calculated as follows:

CSM at the start of the reporting period

plus the effect of any new contracts added to the group (see question 6.6);

plus the value of interest accretion (see question 6.7);

plus the changes in fulfilment cash flows relating to future service (see questions 6.8 – 6.11);

plus the value of currency exchange differences; and

less the amount recognised as insurance revenue because of the transfer of services (see questions 6.12 – 6.20)

= CSM at end of the reporting period.

6.6. What is the effect of any new contracts added to the group?

For any new contracts added to a group of insurance contracts during the reporting period, the entity includes only contracts recognised during the reporting period. New contracts can be added to the group after the end of the reporting period (subject to all contracts in the group being issued no more than one year apart), in accordance with paragraph 28.

6.7. What interest rate is accreted on the CSM?

Interest is accreted on the carrying amount of the CSM during the reporting period using the discount rate applied on initial recognition to reflect the time value of money (paragraphs 44(b) and B72(b)). This discount rate is applied to nominal cash flows that do not vary based on the returns of any underlying items. For further details on determining discount rates see chapter 3.

6.8. Which changes in fulfilment cash flows qualify for adjusting the CSM?

Paragraph 44(c) states "[*the CSM is] adjusted for the changes in fulfilment cash flows relating to future service as specified in paragraphs B96–B100, except to the extent that:*

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

Table 6.1 summarises which components underlying the fulfilment cash flows qualify for adjusting the CSM under the Core Requirements for contracts without direct participation.

Table 6.1: Which changes in fulfilment cash flows qualify for adjusting the CSM?

Item	Unlock CSM?
Change in present value of cash flows related to future coverage and other services due to:	
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 locked-in discount rates (paragraph B96(a))	Yes
Changes in estimates of the present value of the future cash flows in the liability for remaining coverage (e.g., assumption changes), measured at the locked-in discount rate (paragraph B96(b))	Yes
Differences between the actual and expected investment component paid in the period, measured at the locked-in discount rate (paragraph B96(c)	Yes
Contract holder info changes	Yes
Contract feature changes	Yes
Change in value of underlying items, if applicable	No
Risk adjustment for non-financial risks that relate to future service (paragraph B96(d))	Yes
Change in estimates that do not relate to future service:	
Time value of money and financial risks (paragraph B97(a))	No
Change in estimates of fulfilment cash flows in the liability for incurred claims (paragraph B97(b))	No
Experience differences on current period cash flows (paragraph B97(c))	No

6.9. What is the experience investment component?

If, due to actual experience differing from expected experience, an investment component of the contract, i.e., an amount to be repaid to the policyholder under all circumstances, is not repaid in the current period, it will be repaid in future. Since this repayment was not originally included in the estimate of future cash flows, the estimate is increased by the present value of the future repayment at a later estimated repayment date.

A change in the estimate of such future cash flows adjusts the CSM (paragraph B96 (b)), i.e., decreases it by the present value of the future repayment of the investment component, applying the locked-in rate according to paragraph B72 (c).

Except for amount resulting from the discounting effect, the adjustment is reversed by a second adjustment, adding the difference between the investment component expected to be paid in the current period and the one actually paid, i.e., none, to the CSM (paragraph B96 (c)).

The opposite bookings apply if an investment component is repaid in the current period although it was expected that it would be repaid in a future period.

6.10. How are changes in the risk adjustment for non-financial risk reflected in CSM?

The CSM should be adjusted for changes in the risk adjustment for non-financial risk relating to services provided in future periods (paragraph B96(d)), subject to the condition that the CSM should not be negative. Changes in the risk adjustments for non-financial risk relating to coverage and other services provided in the current or past periods should be recognised in profit or loss.

The entity can disaggregate the change in risk adjustment for non-financial between the insurance service result and insurance finance income or expenses (paragraph 81). If the entity does not disaggregate in this way, then the entire change in risk adjustment is disclosed as part of the insurance service result.

The CSM is not affected by the approach adopted for presentation.

6.11. Does a change in the discretionary cash flows paid to policyholders during the reporting period for an insurance contract without direct participation features change the CSM?

Yes, if the entity has discretion over the cash flows to be paid to policyholders for insurance contracts without direct participation features, then a change in the discretionary cash flows is regarded as relating to future service, and adjusts the CSM (paragraph B98).

To determine how to identify a change in discretionary cash flows see paragraphs B98-B100.

Transfer of Services

6.12. How is the transfer of services determined?

The amount of CSM recognised in profit or loss for a group of insurance contracts in each period reflects the services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e) and B119).

The amount of the CSM for the group at the end of the period, before allowing for the transfer of services, is after interest accretion, adjustment for changes relating to future service for cash flow estimates, premiums received and risk adjustment; investment component experience etc.

The entity allocates the CSM at the end of the period equally to each coverage unit (see question 6.13) provided in the current period and those expected to be provided in the future within the contract boundary, and recognises in profit or loss the amount allocated to the coverage units provided in the current period.

6.13. What is a coverage unit?

The coverage units establish the amount of the CSM to be recognised in profit or loss for services provided in the period. Coverage units reflect "*the quantity of the benefits provided under a contract and its expected coverage duration" (*paragraph B119(a)).

Aspects of IFRS 17 relevant in interpreting coverage unit are:

The **coverage period** is defined in IFRS 17, Appendix A as:

> *"The period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract."*

The **insured event** in turn is defined as

> *"An uncertain future event covered by an insurance contract that creates insurance risk."*

The **insurance risk** in turn is defined as:

> *"Risk, other than financial risk, transferred from the holder of a contract to the issuer."*

The application guidance (paragraphs B7-B32) discusses what constitutes insurance risk.

The recognition of CSM in insurance revenue as being related to the transfer of services (paragraphs 44 and 45)

> *"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."*

Paragraphs BC279-BC282 set out the IASB's thinking and rationale for the release of the CSM and the use of coverage units for this purpose. In particular, the following were discussed and rejected by the IASB as the basis for release of the CSM:

a) pattern of expected cash flows (BC279(a));

b) the change in the risk adjustment caused by release from risk (BC279(a));

c) when the returns on investment components occur even where this drives total expected fee (BC280); and

d) release based on services other than insurance service (Last sentence of BC280).

A discussion about how to determine the quantity of benefits in an insurance contract when determining the coverage units of a group of contracts was discussed initially at the

IASB's February 2018 TRG (paper AP05) and considered further and in more depth at the IASB's May 2018 TRG (paper AP05 and IASB TRG Meeting Summary)). It was observed that:

IFRS 17 established principles, not detailed requirements, and detailed requirements would not work appropriately in all cases;

determination of coverage units is not an accounting policy choice, but requires application of careful judgement and consideration of the facts and circumstances to best achieve the principle of reflecting the services provided in each period;

the analysis of the examples discussed at the May 2018 meeting reflects the fact pattern of each example and does not necessarily apply to other fact patterns;

In considering how to achieve the principle, it was observed by the TRG members that:

a) lapse expectations are included to the extent they affect expected duration of coverage;

b) the different levels of service across periods needs to be reflected in determination of coverage units;

c) the quantity of benefits is determined from the policyholder perspective not the quantity of benefits expected to be incurred by the insurer;

d) a policyholder benefits from the insurer standing ready to meet valid claims should the insured event occur, hence the quantity of benefits relates to amounts that can potentially be claimed;

e) different probabilities of insured events across periods do not of themselves affect the stand-ready quantity of benefit provide to a policyholder, but where there are different types of insured events, their different probabilities might affect the stand-ready benefit provided by the insurer; and

f) particular method(s) are not specified by IFRS 17 and different methods may achieve the objective of reflecting the service provide in each period.

6.14. What service should be reflected in coverage units?

The IASB's May 18 TRG considered, for contracts with direct participation features, the question of what services should be reflected in coverage units (e.g., purely insurance or insurance and investment) and the staff analysis concluded that:

IFRS 17 identifies only direct participation contracts as providing both insurance and investment services;

the reference to services in paragraphs 45 and B119 relates to insurance and investment service;

the reference to quantity of benefits in paragraph B119(a) relates to both insurance and investment services;

the reference to expected coverage duration in paragraph B119(a) relates to the duration of insurance and investment services; and

it is necessary, given the tight link of the coverage period to the provision of coverage of insured events in IFRS 17, to make a narrow amendment to clarify that, for direct participation contracts, the coverage period relates also to the provision of investment services.

Members of the TRG generally did not agree with the view that investment service was only present for direct participation contracts, and argued that insurance contracts without direct participating features can have investment components but cannot provide investment services, only insurance services. Profits are derived from investment components, but they can only be recognized in proportion to providing insurance services.

It is worth bearing in mind, that for stand-alone investment contracts with discretionary participation features, the coverage units are based on the investment service, and hence when the returns on the underlying items occur. For contracts that are measured using the VFA, coverage units can reflect investment as well as insurance services.

The way in which this is determined will need to be considered.

6.15. Are there examples available of coverage units?

The appendices of the IASB's May 2018 TRG paper AP05 contain a large number of examples and the paper contains the IASB staff's analysis of potential views of what coverage unit means in the context of specific facts and circumstances. These might be helpful in aiding understanding but only in the context of the specific set of facts and circumstances outlined in the paper.

6.16. Which proxies (e.g., premium and passage of time) can be used as coverage units?

The following methods may be reasonable proxies depending on the facts and circumstances (this is a non-exhaustive list).

(i) Straight line allocation over time but reflecting the expected number of contracts in the group.

(ii) Use of maximum contract cover in each period.

(iii) Use of cover amounts for which the policyholder could validly claim each period should insured event occur.

(iv) Use of premiums, but not if they:

a) are receivable in different periods to the insurance services; or

b) reflect different probabilities of claim for the same insured event in different periods rather than different levels of stand-ready service; or

c) display different levels of profitability in contracts rather than the stand-ready service.

6.17. How do you deal with multiple benefits on a single contract?

Alternative approaches which may be helpful when dealing with multiple benefits on a single contract are outlined below (this is not an exhaustive list).

- Determine coverage units based on the individual benefit components separately and adjust the CSM according to the recognition of all relevant coverage units during the period.
- Consider whether a coverage unit reflecting the characteristics of all benefits can be determined.
- Consider whether the contracts can be separated into components for the purposes of measurement. The TRG covered considerations relating to the separation of insurance components during its February 2018 meeting.

6.18. Can coverage units be calculated net of reinsurance?

No. As underlying business and reinsurance are valued and reported separately, coverage units need to be determined gross rather than net.

6.19. When does the coverage period start and end?

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

Coverage would normally be the effective date of the insurance contract. In some circumstances, coverage may:

- start later, e.g., for travel insurance coverage may only start from the date of travel; or
- appear to start earlier, e.g., a reinsurance treaty may provide cover on claims notified basis (e.g., for emergence of claims not yet reported to the cedant but arising prior to the start date). However, in this case, coverage of notified claims only starts from the start date of the reinsurance contract, and would only start earlier than the start date of the treaty if the treaty also specifically covers claims notified prior to its start.

Normally coverage will cease at the end date specified in the contract, or contract boundary if earlier, or in many cases upon a valid claim arising before the end date. Depending on the nature of the contract, any claims arising from events occurring after that time may not give rise to a valid claim under the contract. Note that notification or settlement of the claim may occur after the end date and the claim amount payable ultimately may continue to develop after the end of the coverage period. However, these are part of the incurred claim liability and do not represent the provision of further coverage.

In other cases, e.g., stop loss reinsurance, while a sequence of independent events might trigger the incurrence of a claim, such events of themselves are not part of the coverage,

it is the occurrence of underlying claims for amount that in total trigger a stop loss claim. Here coverage is for claim payments arising in excess of the stop loss attachment point and again coverage starts from the point at which a valid claim could be made under the contract and not the underlying individual events.

Further, subsequent events may change the amount of the claim ultimately payable but they represent development of the claim amount and not the provision of further cover, e.g., an accident may cause a disability which gives rise to the payment of an annuity for the remaining life of the person disabled. In this case, the cover is for the occurrence of an event which causes such disablement.

6.20. Can the coverage units include discounting?

Yes, coverage units can include the impact of time value of money.

IFRS 17 is silent on whether time value of money needs to be allowed for in determining the release pattern for the CSM and paragraph BC282 makes it clear that this has been deliberately left to the discretion of the reporting entity.

An example of discounting and not discounting coverage units is provided in IFRS 17 Illustrative Example 2, IE17(e).

Subsequent Measurement: Contracts with Direct Participating Features

6.21. How does subsequent measurement of the CSM differ for insurance contracts with direct participating features?

For insurance contracts with direct participating features, the entity substantially provides insurance and investment related services and is compensated for the services by a fee that is determined with reference to the underlying items. The CSM is subsequently measured similarly as for contracts without direct participating features (see question 6.5) except in relation to:

1 the entity's share of the change in the fair value of the underlying items (see question 6.22);

2 the interest rate accreted to the CSM (see questions 6.23 – 6.24); and

3 any financial risk mitigation using derivatives (see question 6.25).

The amounts that adjust the CSM do not need to be identified separately. For example, entities need not identify the adjustments to the CSM for changes in the entity's share of the change in the fair value of underlying items separately from those related to changes to the fulfilment cash flows related to future services. A combined amount can be identified for some or all of them (paragraph 45).

Please also see the answer to 8.12.

6.22. How do changes in the fair value of underlying items impact the CSM?

Changes related to the entity's share of the fair value of the underlying items – i.e., the variable fee – relate to future service and adjust the CSM except to the extent that:

- the entity meets the conditions for the financial risk mitigation option and chooses to adopt it;
- the entity's share of a decrease in the fair value of the underlying items exceeds the carrying amount of the CSM, giving rise to a loss; or
- the entity's share of an increase in the fair value of the underlying items reverses losses previously recognised.

6.23. Is the CSM adjusted for changes in the effect of time value of money and financial risks not arising from the underlying items?

Changes in fulfilment cash flows arising from time value of money and financial risks are regarded as part of the variable fee and recognised in the CSM unless the changes exceed the CSM or the risk mitigation option is taken (refer paragraph B115).

6.24. Which discount rates should be used to calculate the CSM?

No explicit interest is accreted on the CSM since it is re-measured when it is adjusted for changes in financial risks.

6.25. What is required to use and the implications of using the financial risk mitigation option?

Paragraph B115 provides an option for an entity to reduce an accounting mismatch between the measurement of derivatives to mitigate financial risk and the insurance liability. Derivatives are generally measured under IFRS 9 at fair value through profit or loss. For direct participation contracts, changes in the carrying amount of the fulfilment cash flows related to financial risks adjust the CSM instead of being recognised immediately in profit or loss, regardless of whether they relate to the entity's share of the underlying items.

An entity can choose to apply the option of not adjusting the CSM for some changes in the fair value of underlying items (paragraph 45(b)(i)) or the fulfilment cash flows relating to future service (paragraph 45(c)(i)) if it uses derivatives to mitigate the financial risk arising from the insurance contracts and paragraph B115 applies.

For without direct participation contracts, such an accounting mismatch does not arise as changes in the carrying amount of the fulfilment cash flows related to financial risks do not adjust the CSM.

Onerous Contracts

6.26. What is an onerous group of contracts and how are they treated in profit or loss?

A group of contracts is considered onerous if the CSM would otherwise be negative, i.e., there are future losses expected on the contract after including allowance for the risk adjustment for non-financial risk. This can occur at outset or occur on subsequent measurement if the following amounts exceed the CSM:

(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.

The amount by which the contract is onerous is recognised immediately as a loss when it is known that it is loss making (paragraph 48).

6.27. When are onerous contracts recognised?

A group of onerous contracts needs to be recognised when the group is identified as being onerous, even if this is before coverage has commenced or the first premium is due (paragraph 25).

6.28. What is a loss component?

The loss component represents the amount of losses arising from onerous contracts which are available for reversal. They are excluded from the determination of insurance revenue (paragraph 49), i.e., they are not reflected directly in the financial statements.

6.29. How is the loss component tracked over time?

The loss component is tracked and adjusted over time for further losses and loss reversals by:

allocating any changes in the fulfilment cash flows due to changes in estimates of future cash flows relating to future service, which if:

i) unfavourable increase the loss component and give rise to a further loss; or

ii) favourable reduce the loss component, give rise to loss reversal and re-establishment of CSM once loss component is extinguished.

allocating the remaining change in the fulfilment cash flow of the group on a systematic basis between the loss component and the balance of the liability for remaining coverage (paragraphs 50(a) and 51). Changes to fulfilment cash flows to be allocated (per paragraph 51) are:

i) estimates of the present value of future cash flows for claims and expenses released from the liability for remaining coverage because of incurred insurance service expenses;

ii) changes in the risk adjustment for non-financial risk recognised in the profit or loss because of release from risk; and

iii) insurance finance income or expenses.

The systematic basis used needs to ensure the loss component is extinguished by the end of the coverage period of the group (paragraph 52). This can be done for example by using:

- the same release method that would have been applied to the group if there had been CSM (e.g., coverage); or
- the opening balance of the loss component as a percentage of the future cash flows and risk adjustment relating to future service (see Illustrative Example 8).

Note that while the loss component is not specifically recognised on the financial statements a reconciliation of opening to closing balance of the loss component needs to be disclosed (see paragraph 100(b)).

6.30. How are onerous contracts dealt with if they are acquired through a transfer of business?

Paragraph B95 outlines that the amount identified as being onerous can be classified as either goodwill or as a loss on contracts acquired in a transfer. (See question 6.37 for more detail.)

Reinsurance Contracts Held

6.31. How is the CSM determined at initial recognition for reinsurance held?

A CSM is determined for a reinsurance held contract at initial recognition using the same approach as for the underlying insurance contract except the concept of an 'onerous' reinsurance held contract does not exist (paragraph 68). This difference means the CSM can both:

reduce the reinsurance held asset (i.e., present value of reimbursements from the reinsurance contract exceed the present value of reinsurance premiums) and therefore defer recognition of profit from the reinsurance contract; or

increase the reinsurance held asset (i.e., present value of reinsurance premiums exceeds the present value of reimbursements from the reinsurance contract) and therefore defer recognition of losses from the reinsurance contract (see paragraph 65(a)).

The following table shows the measurement of a reinsurance contract where the CSM is negative (i.e., a net cost of purchasing reinsurance - scenario 1) versus when the CSM is positive (i.e., a net gain of purchasing reinsurance - scenario 2). This assumes the risk of non-performance of reinsurer to be negligible.

Table 6.2: Illustrative example of CSM for a Reinsurance Contract

	Scenario 1	Scenario 2
Present value of cash inflows (recoveries)	• (500)	• (500)
Present value of cash outflows (premiums paid)	• 750	• 450
Risk adjustment for non-financial risk	• (50)	• (50)
Fulfilment cash flows	• 200	• (100)
CSM	• (200)	• 100
Reinsurance contract asset on initial recognition	• -	• -

6.32. At initial recognition, does the existence of reinsurance held impact the determination of the CSM and onerous contract testing of the gross policy liabilities?

No, because the principle of IFRS 17 (paragraph B66(b)) is to separately recognise the underlying gross liabilities from any associated reinsurance held, the determination of CSM, as well as onerous contract testing of the gross policy liabilities.

As an example, a contract which is onerous at inception on a gross basis would still be considered onerous and accounted for as such even where 100% of this risk is ceded to another party on an original terms coinsurance basis. In this example, the reinsurance held asset would not offset the impairment on the gross liability (i.e., asymmetric accounting, with the practical consequence of a day one loss from the gross liability impairment offset by income from the reinsurance ceded asset over the lifetime of the reinsurance contract).

6.33. How is the CSM on reinsurance held determined at subsequent measurement?

The subsequent measurement of the CSM for reinsurance held is performed using the same approach as for the underlying insurance contract, albeit on the general measurement approach, except when the underlying gross contract(s) becomes onerous (or is already onerous and becomes more or less so) due to changes in fulfilment cash flows relating to future service. In such circumstances, the change in fulfilment cash flows for the reinsurance held also does not adjust the CSM of the reinsurance held under paragraph 66(c)(ii).

Note: the criterion for not adjusting the CSM of reinsurance held does not require underlying contracts to be or have become onerous. The only requirement under paragraph 66(c) is that changes in reinsurance fulfilment cash flows results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the CSM for the group of underlying insurance contracts.

In these circumstances it is possible that the offsetting impact on the reinsurance held may exceed that on the underlying contracts due to accounting mis-matches that could arise between the reinsurance and the underlying contracts (e.g., due to different contract boundaries or measurement approaches).

6.34. How is the reinsurance CSM adjusted when the change in reinsurance fulfilment cash flows relates to an underlying portfolio using PAA?

When the gross liability is determined using the PAA, there are different views as to how paragraph 66(c) applies. Two of these are outlined below.

View (A): Only when the underlying portfolio is onerous is the reinsurance CSM not adjusted. The argument for this is as follows:

(i) This is consistent with the rationale given by IASB that where an underlying group becomes onerous due to changes in estimates for future service then the reinsurance CSM should not be adjusted, creating an offset (BC315);

(ii) Estimates for future service only occur under PAA when the portfolio is onerous (see paragraphs 57-58);

(iii) Criteria for not adjusting reinsurance CSM under paragraph 66(c) are that there is a change in underlying fulfilment cash flows for future service which does not adjust the CSM of the underlying group. Such change only occurs under PAA when contracts are onerous, as otherwise underlying fulfilment cash flows are not measured under PAA;

View (B): The reinsurance CSM is never adjusted when the change in reinsurance fulfilment cash flows relates to an underlying portfolio using PAA even when the underlying cash flows are not onerous as:

(i) there is no CSM under PAA, any change to reinsurance cash flows relating to underlying portfolio does not adjust the CSM of the underlying; and

(ii) the criteria in paragraph 66(c) do not require an actual change in fulfilment cash flows for the underlying, just that the change in fulfilment cash flows of the reinsurance contract that relate to the underlying and do not change the CSM of the underlying group.

6.35. How is the grouping of contracts for CSM impacted by the fact that reinsurance contracts may cover multiple years of underlying policies?

IFRS 17 prohibits grouping contracts issued more than one year apart. Reinsurance contracts held are aggregated differently to the underlying contracts (paragraph 61), in particular they are treated as a separate portfolio from the underlying and are grouped based on the characteristics and inception dates of the reinsurance contract, not the underlying.

This will require careful consideration when matching up which adjustments to the CSM are restricted (as per question 6.33) as there may be multiple underlying groups and no one to one correspondence between contracts or benefits reinsured.

Other Issues

6.36. How is the CSM calculated for business combinations and transfers of insurance contracts at initial recognition?

Unless the PAA for the liability for remaining coverage applies, on initial recognition the CSM is calculated applying paragraph 38 for acquired insurance contracts issued and paragraph 65 for acquired reinsurance contracts held using the consideration received or paid for the contracts as a proxy for the premiums received or paid at the date of initial recognition.

If acquired insurance contracts issued are onerous, applying paragraph 47, the entity shall recognise the excess of the fulfilment cash flows over the consideration paid or received as part of goodwill or gain on a bargain purchase for contracts acquired in a business combination or as a loss in profit or loss for contracts acquired in a transfer. The entity shall establish a loss component of the liability for remaining coverage for that excess,

and apply paragraphs 49–52 to allocate subsequent changes in fulfilment cash flows to that loss component.

See chapter 11 for a further discussion of on business combinations and portfolio transfers.

6.37. How is the CSM calculated at transition?

The measurement of the CSM or loss component under the full retrospective, modified retrospective and fair value approaches at transition is discussed in chapter 12 on transition.

6.38. What needs to be presented?

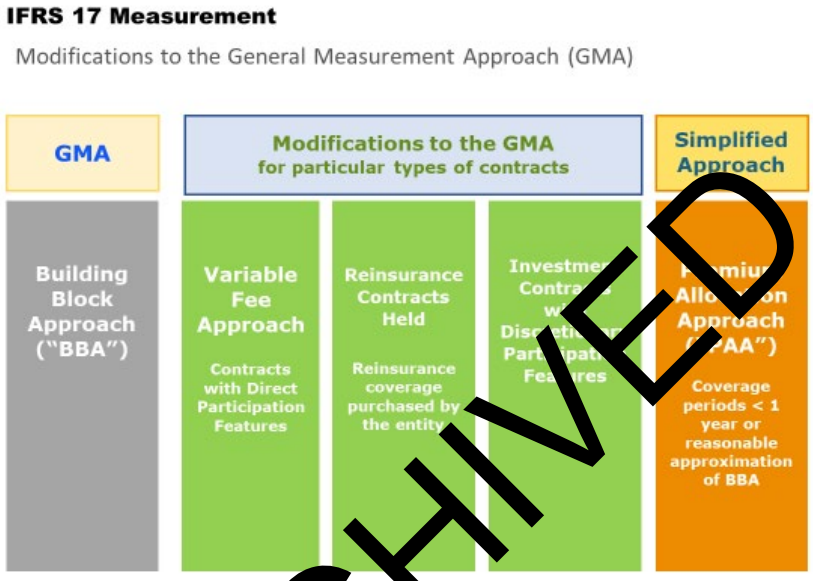
If an entity chooses to adopt the financial risk mitigation option (see question 6.25), then it discloses the effect of that choice on the adjustment to the CSM that would otherwise have been made in the current period (paragraph 112).

See chapter 15 for a discussion on what to present relating to the CSM.

Section B – Variations to the General Measurement Approach

This section includes three chapters that cover the variations to the GMA. These are:

- The Premium Allocation Approach – Chapter 7
- Contracts with Participation Features and Other Variable Cash Flows – Chapter 8
- Reinsurance Contracts Held – Chapter 9



As discussed in chapter 7 the PAA may be used whenever it provides a good approximation to the GMA liability for remaining coverage. It may also be used for groups of contracts with a coverage period of one year or less, regardless of whether it provides a good approximation. Many non-life insurance contracts satisfy this criterion. However, longer-term annual renewable contracts may also satisfy this criterion, if the contract boundary lies at the next renewal date.

As discussed in chapter 8, the circumstances as to when the VFA may be used are not always straightforward especially for contracts with direct participation features which may well vary by jurisdictions. Although not insurance contracts, investment contracts with discretionary participation features are in scope of IFRS 17 *"provided they are issued by an entity that also issues insurance contracts"*. If so these contracts are measured in the same way as contracts with direct participation features.

Whilst reinsurance contracts issued by an insurer/reinsurer are accounted for using the GMA, there are variations as to how an entity accounts for reinsurance held. This is discussed in chapter 9.

Chapter 7 – Premium Allocation Approach

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

7.A. What does this chapter address?

This chapter considers the use of the premium allocation approach (PAA) under IFRS17 including the criteria applying to an insurance contract which must be met for an entity to choose this method, the measurement approach and the differences between this approach and the general measurement approach. The chapter focuses on the "liability for remaining coverage" where most of the differences between the PAA and the general measurement approach are found, although minor differences for the "liability for incurred claims" are noted. Presentation and disclosure for PAA is discussed in chapter 15.

7.B. Which sections of IFRS 17 address this topic?

Paragraphs 18, 53-59, 69-70, 72(c), B72(d),(e)(iii), B126-B127, B193 provide guidance.

BC288–BC295 provide background on this topic.

7.C. What other IAA documents are relevant to this topic?

None

7.1. What is the premium allocation approach?

The premium allocation approach (PAA), which is set out in paragraphs 53-59, is a simplification of the measurement basis in IFRS 17 paragraphs 32–52 (referred to in this IAN as the general measurement approach (GMA), see the introduction to Section A of this IAN). Paragraph 53 states that an entity may use the PAA to measure the liability for remaining coverage, if it reasonably expects that the PAA would produce a measurement for a group of contracts that would not differ materially from the one that would be produced applying the GMA, or if the coverage period of each contract in the group is one year or less. The IASB has stated there is only one model, the GMA, for measuring insurance contracts. (See question 7.2 unten.)

The PAA primarily applies to the liability for remaining coverage, the obligation that relates to the unexpired portion of the coverage period. With the exception of a couple of simplifications under the PAA (paragraph 59), the liability for incurred claims is measured under the GMA, which is discussed in chapters 2 through 6.

The remainder of this chapter considers questions relevant to when and how the PAA may be used. In particular, see questions 7.10 and 7.11 for more information on how the subsequent liability for remaining coverage is measured under the PAA.

7.2. When might an entity choose to use the PAA?

Whilst the PAA represents a mathematical simplification of the GMA, when an entity decides to implement the PAA will depend on the circumstances of each entity. For

example, an entity may prefer to use the PAA where it can be implemented with fewer practical changes to existing systems and processes than might be required to develop an approach to implement calculating and reporting the CSM under the GMA. However, if not all an entity's contracts may be eligible for the PAA, then an entity may need to consider whether there are benefits to implementing the PAA for eligible contracts and developing an approach to implementing the GMA for other contracts or whether to implement the GMA for all contracts.

The PAA is similar to the unearned premium approach used by many entities for reporting unexpired coverage under IFRS 4, local GAAP and/or regulatory reporting for short duration contracts. However, the PAA is not exactly the same as some unearned premium approaches and adjustments may be required. Therefore, entities may need to consider the benefits and disadvantages of implementing the PAA or the GMA for contracts that are eligible to use the PAA.

Considerations for entities in deciding whether to use the PAA might include, for example, the extent to which existing and potential future contracts are or are not eligible for the PAA; the extent to which existing systems and processes may or may not support reporting the PAA for eligible contracts; and the additional resource and cost that may or may not be required to implement the GMA compared with PAA.

7.3. What are portfolios and groups of contracts?

An important concept to understand when reading this chapter is the level of aggregation under IFRS 17. Refer to chapters 1 Classification of contracts and 5 Unit of account.

7.4. When can the PAA be applied?

The PAA can be applied if the conditions in paragraph 53 are met. Paragraph 53 states

An entity may simplify the measurement of a group of insurance contracts using the premium allocation approach set out in paragraphs 55–59 if, and only if, at the inception of the group:

a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the requirements in paragraphs 32–52; or

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

While the PAA is primarily for groups of short-duration contracts, it is allowed whenever it provides a *materially equivalent measure* (in this chapter referred to as good approximation) to the GMA liability for remaining coverage (paragraph 53(a)), thus it is not able to differ materially. It is, however, qualified by paragraph 54 (see question 7.5).

Paragraph 53(b) allows the PAA to be used for groups of contracts with a coverage period of one year or less, regardless of whether it provides a good approximation. The length of

the coverage period depends on the contract boundary (see question 7.8). Many non-life insurance contracts satisfy this criterion. However, longer-term annual renewable contracts may also satisfy this criterion, if the contract boundary lies at the next renewal date.

Use of the PAA is optional. The GMA can always be used, even where the PAA is allowed. The PAA was introduced mainly to provide a simplified approach for general insurance contracts and short-duration risk insurance more generally. It might be suitable for many single-premium contracts. It may also be suitable for regular-premium contracts, where each premium is commensurate with the risk for the corresponding period of coverage. For more complex contracts, it may not prove simpler in application than the GMA, particularly if the time value of money must be allowed for.

Another consideration is consistency. An entity writing general insurance contracts may prefer to go to some extra effort in testing if the PAA can approximate the GMA in order to use the PAA for as many contracts as possible. This might allow such an entity to use consistent reporting of the whole business and remove the additional burdens of measurement under the GMA in the pre-claims period, such as the more detailed disclosure requirements of the GMA. Conversely, an entity writing life insurance contracts may prefer to use the GMA, rather than the PAA, even for simpler contracts, for consistency with how most of its contracts will be measured and presented.

7.5. When is the PAA not allowed?

The PAA cannot be applied in circumstances outlined in paragraph 54 which states:

> *The criterion in paragraph 53(a) is not met if at the inception of the group an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the liability 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 contracts.*

The PAA may have a greater risk of not producing a reasonable approximation to the GMA in the following example scenarios, noting this is not intended to be an exhaustive list:

Scenario	**Reasoning**
Patterns of the expected incurred claim costs and the release of the risk adjustment are significantly different from each other, during the coverage period.	The PAA approach reduces the liability for remaining coverage in line with the pattern of incurred claim costs while the GMA would consider the impact of both in the relevant building blocks potentially leading to significant differences in the value of the liability for

	remaining coverage under the PAA versus the GMA over the coverage period.
The pattern of expected incurred claim costs is highly uneven and the CSM is significant under the GMA.	The CSM is released in accordance to the insurance service provided which is based on coverage units for the duration of coverage. If the coverage provided by a contract is the same over the coverage period, then the CSM would be expected to be amortized evenly for each coverage period. For the PAA, an uneven pattern of expected incurred claims would result in an uneven pattern of premium allocated to each period. The size of the CSM would then determine the significance of this difference.
The longer the expected payout pattern is for the coverage and/or the higher the interest rate environment.	Significant variability in the cash flows may occur during the coverage period if the time value of money is a major component of the underlying building blocks of the GMA. For very long payout patterns, such as excess workers' compensation coverage, even a small change in a low interest rate environment could significantly change the value of the liability for remaining coverage. In a high interest rate environment, interest rates tend to be more volatile, and discount can make up a significant portion of the liability for remaining coverage even for shorter tailed non-life business.
In a high interest rate environment where there is no significant financing component and the premium is due within a year of providing the relevant coverage.	In this situation an entity is not required under the PAA to reflect the time value of money in the liability for remaining coverage but would be required to do so under the GMA.
In a high interest rate environment where there is significant financing component.	In this situation an entity is required under the PAA to reflect the time value of money in the liability for remaining coverage using a discount rate locked in at initial recognition. A high interest environment tends to be volatile and an entity that used the GMA without a locked in discount rate may produce a significantly different answer for the liability for remaining coverage than the PAA.

There is a significant investment, service or other non-insurance component to the contract, or there is a significant profit sharing component.	These are complications which the PAA was not designed to handle and where it might not approximate the GMA.
The cost of any embedded options or derivatives is significant	Paragraph 54 (a) of the standard tells us that increasing amounts of embedded derivatives is an example of where variability in the fulfilment cash flows could be significant.
Coverage is deferred	While the PAA might require the liability for remaining coverage to accrete interest, the longer the deferral period the greater the mismatch is likely to occur between the underlying building blocks of the GMA and the PAA's liability for remaining coverage. The GMA will continue to update expectations of future cash flows while the PAA will only adjust for changes in the timing for incurred claims in the coverage period per paragraph B127.
Longer duration contracts generally	For many reasons already highlighted, the longer the contract the greater the variability can be in the projected fulfiment cash flows under the GMA.
Situations where there can be significant changes in the initial "written" premium which could include: • Cancellation of policies within the coverage period • Lapses through non-payment of future premiums when premium has not been paid upfront • Contractual premium audits during the coverage period • Reinstatement provisions that could result in additional future premium	Under the PAA, premium is allocated based on the passage of time or incurred claims if the expected pattern of release from risk is significantly different from the passage of time. It does not explicitly reflect cancellations or return of premium, nor future premium from reinstatements or other sources on an expected value basis. Paragraph B126 requires an entity to recognise revenue under the PAA by allocating "expected" premium receipts to each coverage period. No clarity is given on the measurement basis for "expected" premium receipts. The GMA, on the other hand, reflects premium cash flows on an expected value basis, and changes in them during the coverage period for the liability for remaining coverage as expectations change.

Contracts with level expected incurred claims and non-level indirect expenses	The PAA would allocate the premium evenly over the contract period while the GMA would recognise the non-level nature of the indirect expenses in the fulfilment cash flows.

7.6. For contracts whose coverage period is greater than 12 months in length, is it necessary to test whether the PAA is an approximation of the GMA?

The standard does not explicitly require a test to demonstrate that the PAA is an approximation of the GMA. However, relevant stakeholders, such as an entity's auditors, might expect the entity to justify its use for groups of contracts which contain contracts with more than 12 months coverage. The justification required depends on the circumstances, although paragraph 54 suggests that the criterion is evaluated only at inception looking at the measurement of the *"liability for remaining coverage during the period before a claim is incurred"*.

For single premium contracts that run for only a few months more than a year, it may be sufficient to demonstrate that there is no obvious reason why the PAA would not be a good approximation to the GMA over the coverage period.

In some simple circumstances, it may be possible to demonstrate mathematical equivalence between the PAA and the GMA. This may be the case, for example, for single premium contracts, if the expected incurred cost is level over the coverage period, the risk adjustment is a flat percentage of the future cash flows and the PAA reflects the time value of money.

For a longer term group of single premium contracts, it may be desirable to perform a few sample calculations on both bases, in order to confirm that they produce similar results for the liability for remaining coverage.

Where there are future premiums, or any other features that create a greater risk of not producing a reasonable approximation to the GMA (see question 7.5 above), it may be desirable to undertake more exhaustive testing. If this is unduly laborious, it may be an indication that the PAA is not appropriate for use.

If limited testing does not clearly indicate that the PAA is a good approximation, and PAA presentation is strongly preferred for such reasons as consistency with the rest of an entity's business, it may be necessary to undertake parallel calculations to confirm a reasonable approximation.

At adoption of IFRS 17 there may be more emphasis on testing approaches until familiarity amongst practicioners allows qualitative reasoning as a justification in certain cases.

7.7. When is a group of contracts recognised?

The recognition criteria for groups under the PAA are the same as for the GMA. Under paragraph 25 a group is recognised at the "*earliest of the following:*

a. the beginning of the coverage period of the group of contracts;

b. the date when the first payment from a policyholder in the group becomes due; and

c. for a group of onerous contracts, when the group becomes onerous."

The first criterion is consistent with how entities in some jurisdictions that write short duration contracts recognised contracts under local GAAPs and IFRS 4 prior to the effective date of IFRS 17. The second criterion would be triggered if any premium deposit, instalment or the full amount is due prior to the start of the coverage period.

7.8. What is the contract boundary?

The contract boundary is defined by paragraph 34, and discussed in Chapter 1 of this IAN.

The significance of the contract boundary in the context of the PAA lies in whether the contract has a coverage period of one year or less and is therefore automatically eligible for the PAA. For many general insurance contracts, neither insurer nor insured is obliged to renew, so the contract boundary is clear.

The situation is rather less clear for compulsory insurances, where the right of the insurer to set a premium that *fully* reflects the risk is compromised in certain jurisdictions.

In cases of doubt, the actuary may seek guidance from the entity's technical accounting group to reach a consensus on the issue.

7.9. What is the initial measurement approach to the liability for remaining coverage?

The initial measurement under the PAA is set out in paragraph 55(a).

on initial recognition, the carrying amount of the liability is:

i. the premiums, if any, received at initial recognition;

ii. minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense applying paragraph 59(a); and

iii. plus or minus any amount arising from the derecognition at that date of the asset or liability recognised for insurance acquisition cash flows applying paragraph 27.

Under paragraph 59(a), if the coverage period is 12 months or less for each contract in the group at initial recognition the entity "*may choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs*." This may cause a material difference between the PAA and the GMA for the liability for remaining coverage which is why it is only permitted when the coverage period is less than 12 months for each contract in the group and the safe harbour election of the PAA can be made.

Onerous contract liabilities are discussed below (see question 7.14).

For general insurance business, on a single premium basis with the initial recognition when the premium is due, if the option in paragraph 59(a) is not taken, the overall effect is that of an unearned net premium. Instead of an initial unearned premium (UEP) equal

to the written premium, less an initial deferred acquisition cost equal to the deferrable acquisition costs (DAC), the initial UEP is effectively net of acquisition costs and there is no DAC asset.

While initially thought of as a UEP model, the PAA's initial measurement criteria will not provide users of the financial statements with as much information as an unearned premium model grossed up for acquisition expenses and any premium owed. The PAA, through approximating the GMA of netting cash inflows and outflows, will not include the future inforce exposure by the amount of premium owed.

If the 59(a) option is taken, the initial UEP is equal to the premium received, but with no DAC. The effect of this is that the net liability is greater than under previous approaches by the amount of DAC that is not recognised.

This measurement approach does not capture any expectation of policy cancellations. If significant, policy cancellations on premiums paid could result in overstating the liability, or for contracts with a coverage period of greater than 12 months the use of the PAA may not be appropriate per the requirements of paragraph 54 of IFRS 17, which require that there not be an expectation of significant variability in the fulfilment cashflows that would affect the measurement of the liability for remaining coverage.

7.10. What is the subsequent measurement approach to the liability for remaining coverage?

The subsequent measurement under the PAA is also set out in paragraph 55(b) which states

> *at the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:*
>
> *(i) plus the premiums received in the period;*
>
> *(ii) minus insurance acquisition cash flows; unless the entity chooses to recognise the payments as an expense applying paragraph 59(a);*
>
> *(iii) plus any amounts relating to the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period; unless the entity chooses to recognise insurance acquisition cash flows as an expense applying paragraph 59(a);*
>
> *(iv) plus any adjustment to a financing component, applying paragraph 56;*
>
> *(v) minus the amount recognised as insurance revenue for coverage provided in that period (see paragraph B126); and*
>
> *(vi) minus any investment component paid or transferred to the liability for incurred claims.*

As set out in B126, insurance contract revenue is recognised in each accounting period;

> *a) on the basis of the passage of time; but*

b) if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.

Onerous contract liabilities and the circumstances under which the adjustment for the time value of money is required are discussed below (see questions 7.14 and 7.15). In practice, it is possible to turn this procedure around. In the absence of onerous contract liabilities, the PAA liability is the (present) value of future revenue (less future premiums). For single premium contracts where future revenue is pro-rata (see question 7.12 below) and discounting can be ignored, it may be easier to think in terms of UEP and calculate premium revenue as UEP at the start of the period, plus premiums received, minus UEP at the end of the period, similar to previous accounting practice.

7.11. What acquisition expenses should be used in the initial measurement?

Insurance acquisition cash flows is a term defined in Appendix A of IFRS 17 and is used in Paragraph 59(a). Their amount is an accounting determination but might include commissions, underwriting costs and contract set up expenses. For each group, all of these expenses must be directly attributable to the portfolio of insurance contracts to which the group belongs. For more details see chapter 4 on Estimates of future cash flows.

7.12. How is revenue recognised for subsequent measurement periods?

Revenue recognition under the PAA is specified in paragraph B126.

> *… insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect the time value of money and the effect of financial risk, if applicable, applying paragraph 56) allocated to the period. The entity shall allocate the expected premium receipts to each period of coverage:*
>
> *a. on the basis of the passage of time; but*
>
> *b. if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.*

In practice, unless there are particular reasons to expect an uneven pattern, a good starting point might be an *a priori* pro rata assumption, modified to the extent demanded by credible experience. There is an inherent tension between using the largest possible portfolio to maximise credibility and smaller sub-portfolios to detect intra-portfolio variations. The best balance is a matter of judgment.

There is also the question of what does "*differs significantly from the passage of time*" mean? This is not defined by the standard although the term "significant" is often used in accounting frameworks to relate that something has more than a remote likelihood of causing a misstatement. This appears to be a lower threshold than something that is material, an item in accounting that would have an impact on the reader of the financial statement. Some may consider this a matter of accounting, rather than actuarial

judgment, where the actuarial role is to provide the analysis on which that judgment can be based.

For example, the storm damage component of the premium for a home-owners policy in Queensland, Australia, where cyclone season typically falls between November and April, would differ significantly from the passage of time. But other perils insured under the policy may have no such pattern, or even offsetting patterns. Other types of policies may have more subtle seasonal effects that would, due to the large number of policies sold, have a significant impact on revenue. For example, auto policies in the northern states of the US incur 72-74% of incurred losses over the first nine months of a calendar year with the remaining 26-28% being incurred over the last quarter with the inclement winter months. This difference is subtle in terms of ultimate loss but might have a significant impact on the revenue recognition and bottom line profit of the company if the premium was recognised in line with the expected timing of incurred claims.

7.13. How should the liability for incurred claims be measured for contracts valued using the PAA?

The PAA is primarily a simplification of the measurement approach for the liability for remaining coverage under the GMA. However, there are a couple of minor simplifications that are permitted when measuring the claim liabilities, or the liability for incurred claims, if the contracts are initially measured under the PAA.

For contracts measured under the PAA, the liability for incurred claims is measured using the GMA with one potential modification, the entity is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred, as per paragraph 59 (b).

The GMA allows for an entity to elect to lock-in interest rates for purposes of recognising finance income or expenses over the life of a contract, with changes in market rates going through other comprehensive income (OCI). Based on paragraphs B133 and B72 (e) (iii), an entity that has used the PAA for measuring the liability for remaining coverage and wishes to lock-in discount rates shall do so based on the incurred date of the claim liabilities, and not the initial contract recognition date as per the GMA. For practical purposes of implementation, one way to do this is to lock-in a discount rate for each group of contracts based on the average accident date of a period (quarterly or annual). This could be justified if the average claim size is assumed to be uniformly distributed over the period.

7.14. When and how should an onerous contract liability be recognised?

Onerous contracts, in the context of the PAA, are the subject of paragraphs 18 and 57.

> 18 *For contracts issued to which an entity applies the premium allocation approach (see paragraphs 53-59), the entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. An entity shall assess whether contracts that are not*

onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.

57 *If at any time during the coverage period, facts and circumstances indicate that a group of insurance contracts is onerous, an entity shall calculate the difference between:*

(a) the carrying amount of the liability for remaining coverage determined applying paragraph 55; and

(b) the fulfilment cash flows that relate to remaining coverage of the group, applying paragraphs 33–37 and B36–B92. However, if, in applying paragraph 59(b), the entity does not adjust the liability for incurred claims for the time value of money and the effect of financial risk, it shall not include in the fulfilment cash flows any such adjustment.

Note that, in the first instance, this test is applied to a group of contracts within a portfolio. Unless there are facts, or other circumstances, supporting the belief that the group of contracts is onerous, it is not necessary to look further at inception whether there is a group of onerous contracts. The latter half of paragraph 18 would indicate that the entity would still need to consider at inception whether to categorise the contracts in the portfolio as belonging to a group that has no significant possibility of becoming onerous in subsequent periods or not, as described in paragraphs 16 (b) and (c), based on the likelihood of the facts and circumstances changing during the coverage period.

Contracts may be onerous at issue or may become onerous later during the coverage period. The wording "*facts or other circumstances*" in this paragraph implies that an explicit test is not required. An explicit test is only needed when there is reason to believe that the portfolio containing the contracts may be onerous. This is clearly a matter of judgment. Possible indicators that may inform the decision to conduct testing include:

a. a group of contracts in the portfolio that are known to be onerous at initial recognition;

b. past losses in the portfolio;

c. aggressive underwriting or pricing;

d. unfavourable experience trends; and

e. unfavourable external conditions.

Groups of onerous contracts might also be identified by parallel GMA and PAA calculations. The excess of the GMA over the PAA liability for remaining coverage is recognised as a loss in P&L and increases the liability for remaining coverage. The GMA liability is discussed in chapters 2 to 6, but may be modified in accordance with paragraph 57(b) to exclude discounting, if the corresponding liability for incurred claims is (or would be) undiscounted in accordance with paragraph 59(b).

If at any time during the coverage period, facts and circumstances indicate that a group of insurance contracts is onerous, it is necessary to recalculate the difference between the GMA valuation of the liability for remaining coverage and the carrying amount (paragraph 57).

An onerous contract liability cannot arise for incurred claims, since these are not part of the liability for remaining coverage and are already valued at current fulfilment value under the GMA.

Onerous contracts are discussed further in chapter 5 on unit of account.

7.15. When is an adjustment made to the liability for remaining coverage for the time value of money required, and how is the adjustment made?

Adjustment for the time value of money is subject to paragraph 56. An adjustment is required where there is a *"significant financing component"* to contracts in a group. It is optional to adjust the liability for remaining coverage for the time value of money, if the time between providing the relevant portion of insurance coverage and the due date for the corresponding premium is expected to be 12 months or less.

The discount rates to be used are as determined at initial recognition of the contract. Interest rates are discussed further in chapter 3.

7.16. If the entity elects to use OCI for changes in interest rates in subsequent measurement periods for the liability for incurred claims, what is the locked-in discount?

If electing the OCI option to minimise the volatility from changes in interest rates in profit and loss, under the GMA the discount rate is locked-in at the start of the coverage period of the contract. The IASB has allowed for a practical difference with the PAA in paragraph B72 (e) (iii) whereby the discount rate is locked in based on the date incurred losses are recognised. Effectively, for practical purposes, for most portfolios of contracts this would imply the locked-in discount rate would be based on the average accident date of a period (e.g., quarterly or annual).

7.17. How is ceded reinsurance dealt with under the PAA?

Under paragraph 69, the PAA may be used for ceded reinsurance contracts, if they meet the same criteria as for direct insurance contracts. For proportional reinsurance, this may be the case if the direct contract is eligible for the PAA assuming the coverage is on a losses occurring basis, where the reinsurer covers losses that occur for a defined period of time under the contract. This is not necessarily true for proportional reinsurance on a policies or risks attaching basis, where the reinsurer covers losses arising from policies written over a defined period of time. For example, if these reinsurance contracts attach policies over a one-year period and the attaching policies are also written over a one-year period then the reinsurance contracts would have a coverage period of two years and would not be automatically eligible for PAA based on coverage of one year or less.

Conversely, non-proportional reinsurance is typically written on a loss occurring basis and may be eligible for the PAA, even if the underlying direct contracts are not, as long as the coverage period is one year or less. Some non-proportional reinsurance is unlikely to

qualify for the PAA. For example, a catastrophe cover for tropical storms and other aggregate covers with a term in excess of one year may not qualify because the pattern of risk is likely to differ significantly from pro-rata over time. See earlier scenarios list in question 7.5.

7.18. How is assumed reinsurance dealt with under the PAA?

Paragraph 3 indicates that the standard applies to "insurance contracts, including reinsurance contracts" an entity issues. IFRS 17 does not explicitly differentiate between the treatment of an issued insurance contract and an issued reinsurance contract. Consequently, the PAA may be used if the reinsurance contract meets the requirements of paragraph 53. It is worth noting again that a risks attaching reinsurance contract, even with a contract length of one year, would not automatically be eligible for the PAA under paragraph 53(b) as the coverage provided would be in excess of one year but it might still be possible to apply PAA.

Under a non-proportional reinsurance treaty, particularly some catastrophe covers, such as those covering tropical storms, and other aggregate covers, the pattern of risk may differ significantly from pro-rata over time and therefore may not qualify for the PAA if the contracts have coverage periods in excess of one year.

7.19. When and how does an entity bifurcate non-insurance features under the PAA?

Non-insurance features are treated in the same way under the GMA and the PAA. Bifurcation is discussed in chapter 2. After bifurcation, the insurance part of the contract is valued in the same way as a standalone contract.

7.20. How are results presented under the PAA?

See chapter 15.

7.21. How is transition to the new standard treated if the entity will measure its liabilities using the PAA?

Transition is discussed in chapter 12. The PAA is not explicitly mentioned in IFRS 17 Appendix C, which covers transition.

It will usually be straightforward to apply the PAA retrospectively in accordance with paragraph C4 when the duration of most PAA contracts is one year or less, but the amount of effort may be dependent on internal data capture and systems. Retrospective implementation will require additional effort for contracts with coverage periods longer than one year.

7.22. How are contract modifications handled under the PAA?

Contract modifications are the subject of paragraphs 72 and 73.

Paragraph 72 indicates that when a contract is modified, "*an entity shall derecognise the original contract and recognise the modified contract as a new contract*". It further notes that the "*exercise of a right included in the terms of a contract is not a modification*" but provides an exhaustive list of conditions under which the contract can be derecognized if,

and only if, one or more of the conditions is met. These conditions include a modification that would have changed the group to which the contract would have been assigned at inception or a modification that would have changed a contract being accounted for under the PAA to no longer being eligible for that simplification.

Paragraph 73 is written in terms of the GMA, indicating that if none of the conditions are met under paragraph 72 the "entity shall treat changes in cash flows caused by the modifications as changes in estimates of fulfilment cash flows by applying paragraphs 40-52". Paragraphs 40-52 detail subsequent measurement under the GMA; therefore, for contracts where the PAA is applied, it would seem appropriate to proceed by applying the guidance for subsequent measurement under the PAA that is in paragraph 55(b).

See also chapter 14 Contract modifications.

Chapter 8 – Contracts with Participation Features and Other Variable Cash Flows

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

8.A. What does this chapter address?

This chapter considers the recognition, measurement and presentation of participating features, particularly in the case of contracts with direct participation features, as well as for other cash flows subject to the discretion of the insurer or linked to indices, including the criteria to be met for those classifications. The specific considerations on transition for participating contracts are covered in chapter 12 – Transition.

8.B Which sections of IFRS 17 address this topic?

Paragraphs 45, 48(b), 71-72, 87, 89 111-113 and B27, B67-B72, B94, B96-B97, B101-B118 provide guidance on this topic.

BC165-BC167, BC171-BC174, BC237-BC249 BC250-BC256 BC 264-BC269 BC276 BC365-BC366 also provides background on the subject.

8.C What other IAA documents are relevant to this topic?

None

General Issues

8.1. What are the types of participating contracts?

IFRS 17 defines different types of participation:

a) An insurance contract with direct participation features (direct participating contract or DPC). The contracts are defined in Appendix A and B101 and are measured using a variation of the approach used for insurance contracts without direct participation features.

b) Investment contracts with discretionary participating features. These contracts are defined in Appendix A and are measured under IFRS 17 rather than IFRS 9.

c) In addition, there are many different types of participating contracts in each jurisdiction that do not meet the criteria of a) or b). The actuaries in each jurisdiction will need to examine each type of insurance contract to see if it meets the requirements to be a direct participating contract (DPC) (see 8.3). For example, some contracts may have discretionary payments that depend on the return on assets but do not meet either of the other requirements. Participating contracts that don't meet all the requirements to be a DPC are measured in the same way as insurance contracts without direct participation features.

In assessing whether a contract is DPC, careful consideration must be made of the impact of guarantees both in terms of guaranteed returns and guaranteed benefit amounts as this will impact whether the requirement of B101(b) and B101(c) are

met (B108). This means there may be groups of insurance contracts within the same product which fail to meet the requirements for direct participation, for example, where different levels of guarantees are chosen by different policyholders. It is possible that some contracts within a product could be measured as DPCs while others are measured as insurance contracts without direct participation features.

8.2. How is reinsurance handled for participating contracts?

Reinsurance contracts, issued or held, never meet the requirements to be a DPC and therefore are measured in the same way as insurance contracts without direct participation features (B109 and explained in BC248-BC249). See also chapter 9 on reinsurance.

Direct Participating Contracts

8.3. What is the definition of a Direct Participating Contract?

DPC are those contracts which meet the following criteria:

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

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

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

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

For a DPC the definition of coverage period includes the period when the contract provides investment services as well as insurance services.

The standard defines "fair value" in several places, such as in the definition noted above. The fair value methodology is consistent with the fair value approach of IFRS 13. For further discussion on the measurement of fair value see the separate chapter – Chapter 10 Fair Value.

8.4. What does a clearly identified pool of underlying items mean?

The requirement is that underlying items are clearly identified by the contract. The definition of underlying items is given in Appendix A and expanded upon in B106:

> *Items that determine some of the amounts payable to a policyholder. Underlying items 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.*

In order to meet the definition, B105 requires that the link to underlying items be "enforceable". Enforceability (paragraph 2) is a matter of law. This can be contractual (contracts need not be written and can be implied by "an entity's customary business practices") and includes those imposed by external parties such as law or regulation.

Enforceability cannot be assumed to apply for example across all products written by an entity.

8.5. What types of items can be included in the pool of underlying items?

B106 provides more information about the composition of underlying items. This could be a reference portfolio or the net assets of the entity. It does not need to be a separately defined fund belonging to the policyholder. The assets do not even need to be held by the entity e.g., the underlying items could be a defined external index.

8.6. *Can profits from portfolios of certain insurance contracts owned by a "participating" fund qualify as underlying items?*

This is likely to depend upon the nature of that income and is an issue that needs to be resolved between the reporting entity and its auditor.

8.7. What are some examples of situations that do not meet the requirements to be defined as underlying items?

A couple of examples are set out in B106 as not meeting the requirements to be defined as underlying items:

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.

This latter example would exclude many traditional participating contracts from qualifying as DPCs.

8.8. What does a substantial share or substantial portion mean?

IFRS 17 does not specifically define what "substantial" means. In B101(b) the requirement is that the policyholder shares in a "substantial share of the fair value returns on the underlying items" and in B101(c) a "substantial proportion" of the amounts paid to policyholders to vary with the fair value of the underlying items.

This is further clarified in B107. The assessment is not made on a period by period basis but rather 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.

8.9. What is the conceptual basis for measuring DPCs?

B104 explains that for a DPC, 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*

Further this variable fee is made up of two components:

> *(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.*

So DPCs create:

> *an obligation to pay policyholders an amount equal in value to specified underlying items, minus a variable fee for service. That fee is an amount equal to the entity's share of the fair value of the underlying items minus any expected cash flows that* ***do not vary directly*** *with the underlying items.*

The detail of this subsequent measurement is set out in B110 – B114 with further comments in BC238 – BC249.

Unlike insurance contracts without direct participation features, however, "all the adjustments are measured using current discount rates".

All these different adjustments do not have to be identified separately (B114).

Note that the PAA, as described in Chapter 7, cannot apply when the insurance contracts meet the definition of a DPC.

8.10. How do DPCs work on initial recognition?

On initial recognition the approach for DPCs is identical to the approach used for insurance contracts without direct participation features. Fulfilment cash flows and a CSM are determined in the same manner as set out in paragraphs 32–39.

8.11. What discount rate is used for measurement?

The discount rate used for cashflows that vary based on the returns on underlying items are discussed in B74 – B77.

The standard allows for different approaches. The cash flows can either be discounted using rates that "reflect that variability", or the cashflows themselves can be adjusted for that variability and discounted at a rate that reflects that adjustment. This is the case regardless of whether the entity actually holds the underlying items or not and whether the variation is set out in the contract terms or a matter of discretion.

Similarly, nominal cashflows (including the effect of inflation) are discounted using a discount rate that also includes the effect of inflation; and real cash flows (excluding the effect of inflation) are discounted at rates that exclude the effect of inflation.

Where minimum guarantees exist, the return is not solely dependent on the return on underlying items and the discount rate is adjusted to allow for the impact of the guarantee, even if the guarantee is lower than the expected return on the underlying items.

The standard does not require entities to divide cash flows into those that vary based on the return on underlying items and those that do not. If a split is not carried out, the discount rate reflects the impact on the combined cashflows. The standard cites both stochastic modelling techniques and risk-neutral approaches as appropriate approaches for doing this. (B77).

8.12. How do DPCs work on subsequent measurement?

DPCs are contracts where the entity's obligation to the policyholder is closely related to the underlying items. The entity's obligation to the policyholder is the net of (see paragraph B104):

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

(b) a variable fee that the entity will deduct from (a), 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 return on underlying items.

This relationship between the entity's obligation to the policyholder and the underlying items requires the contractual service margin for DPCs being updated for more changes than for insurance contracts without direct participation features.

a) The CSM is additionally adjusted for the change in the entity's share of the fair value of the underlying items (see paragraph 45(b) and B112), except to the extent that risk mitigation is applied (see paragraph B115 and question 8.15).

b) There is no explicit accretion of interest on the CSM, as this is implicit in (a).

c) The adjustment for changes in fulfilment cash flows that do not vary based on the returns on underlying items is measured using current discount rates (see paragraph B113(a)).

d) The adjustment for changes in fulfilment cash flows that do not vary based on the returns on underlying items includes the change in the effect of the time value of money and financial risks not arising from the underlying items (see paragraph B113(b)), except to the extent that risk mitigation is applied (see paragraph B115 and question 8.15).

e) Please also note that coverage for investment-related services is included, in addition to coverage for insured events, in the determination of coverage units when releasing the CSM (following the proposed amendments through the [2018] annual improvement cycle).

8.13. What discount rate is used for DPCs on subsequent measurement?

When making adjustments to the CSM for DPCs, all changes are determined using current discount rates. This applies to the entity's share of the change in the underlying items and

also changes in estimates of the fulfilment cash flows (B113). No locked-in interest rate is used.

8.14. What cash flows adjust the CSM in a given period for DPCs?

Changes in the value of the obligation to pay the policyholder an amount equal to the fair value of the underlying items (paragraph B104(a)) do not adjust the contractual service margin as they do not relate to future service (B111).

Changes in the entity's share (paragraph B104(b)(i)) adjust the CSM as they do relate to future service (B112).

Changes in the fulfilment cash flows that do not vary based on the returns on underlying items (paragraph B104(b)(ii)) consist of two categories (B113). Taking the second first (B113(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...*

In B113(a) all other changes in estimates of the fulfilment cash flows apart from those in (b) are treated in the same manner as insurance contracts without direct participation features and hence

> *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.*

8.15. How does risk mitigation such as hedging impact the measurement of DPCs?

If risk mitigation is used then, for DPCs, the entity can choose to put some or all of the changes in the effect of financial risk in the entity's share of the underlying items component of the variable fee (B113(b)) through the CSM. This is to remove accounting mismatches.

This would for example allow the change in the fair value movement in derivatives which goes through P&L to be offset by the equivalent fair value movement in liabilities through P&L, as opposed to the liability impact being spread through the CSM (B115).

There are requirements to do this. These are set out in B116.

"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, i.e., 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) credit risk does not dominate the economic offset."

This means the risk mitigation cashflows used in the fulfilment cashflows may need to be allocated to each group and applied consistently in each reporting period (B117).

Finally, if the conditions required to use this approach are no longer met then the approach cannot be used from that date, however previous periods are not adjusted retrospectively (B118).

8.16. What happens when a DPC is modified?

If the terms of a contract are changed so that the insurance contract no longer meets the requirements for direct participation or vice versa (paragraph 72), the original contract is derecognised and a new contract recognised based on the modified terms. See chapter 14 Contract modifications and derecognition for further details on contract modification.

8.17. Are there any special requirements for a DPC on transition?

There are specific requirements for DPC on transition. Some of the requirements differ from insurance contracts without direct participation features. See chapter 12 – Transition for further details on transition requirements.

Investment Contracts with Discretionary Participating Features

8.18. What is the definition of an investment contract with a discretionary participating feature?

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:

a. that are expected to be a significant portion of the total contractual benefits;

b. the timing or amount of which are contractually at the discretion of the issuer; and

c. that are contractually based on:

(i) the returns on a specified pool of contracts or a specified type of contract;

(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

(iii) the profit or loss of the entity or fund that issues the contract.

The treatment of these contracts is covered in paragraph 71 and B27(a) confirms that these contracts, although not insurance contracts, are in scope of IFRS 17 *"provided they are issued by an entity that also issues insurance contracts"*.

8.19. *What are some examples of investment contracts discretionary cash flows?*

One common example would be discretionary interest payments on a savings-type product.

8.20 How are Investment Contracts with DPF measured?

Investment Contracts with DPF are subject to the same measurement considerations as direct participating contracts – refer to questions 8.3 to 8.17.

Other Participating Contracts

8.21. What are some other types of participating contracts?

Traditional participating contracts where dividends (bonuses) are declared annually after completion of the year, not based directly on the return on a specified pool of underlying assets, are the most common type of contract that may fit here. For example, where there is no enforceable sharing mechanism specified for the participating contracts in question, so the dividend (bonus) can be adjusted to support performance on other contracts, or where the dividend (bonus) does not only depend on changes in the underlying items but also is materially based on sharing of expense or mortality profits as well. There are, however, a great variety of such contracts worldwide so each actuary needs to look at the particular contract under consideration to determine whether it meets the requirements to be a direct participating contract.

8.22. How are cash flows on those contracts measured?

Many insurance contracts exist where there is an element of discretion (either in timing or amount) over the amounts paid to policyholders. Many of these will not meet the requirements for direct participation and hence are measured using the general measurement approach.

For these contracts (without direct participation features), expected discretionary payments are cash flows directly related to fulfilment of the contract and included within the contract boundary (B65). Any change in the discretionary element paid to policyholders that relates to future service adjusts the CSM. In order to assess if such a change has arisen an expected basis for these discretionary payments is included in the fulfilment cashflows at inception. The CSM is then adjusted for deviations from these expected cashflows (B98) subject to the following.

- Changes in these payments can arise as a result of changes in financial risk (these do not adjust the CSM) on those payments and *"discretionary changes to that commitment"* (adjust the CSM) (B99).
- If it is not possible to separate the commitment at inception and the discretionary element then the commitment is defined *"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"*. (B100, BC237).

For some types of contracts, amounts may have accumulated over many decades in participating funds. The ownership of these funds may not be clear cut between

shareholders and policyholders. If difficult judgements with unusual levels of uncertainty are required, this would require suitable disclosure.

When cash flows in one group (either direct participating or not) are impacted by cash flows in another group

8.23. In what circumstances are cash flows in one group considered to be impacted by cash flows in another group?

IFRS 17 recognises that sharing between groups of policyholders arises and has a section on *"Contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts"* (B67 – B71).

This is limited to the sharing that arises from policyholders sharing in the returns on underlying items with other policyholders, including guaranteed payments either to that policyholder or the other policyholders. The basis for conclusions explains that this is a subset of the effect referred to as *"mutualisation"* (BC171) and that IFRS 17 only refers to this specific type of sharing, and other types such as *"the effects of specific contractual terms to general risk diversification"* are not included in the scope of "sharing." The sharing will normally go both ways, so if a group of policyholders shares profits with another group but the second group does not share profits in reverse, this is not the mutualisation case being considered.

Payments and sharing of returns between existing groups of policyholders can be to current or future policyholders (B68(a)) recognising the fact that sharing mechanisms smooth payments over time and it is not possible to determine when or to whom payments will be made at any one point in time.

The important point is not to double count any impacts i.e., payments that have been included in the cash flows of one group are not included again in the cash flows of another.

As in other areas, IFRS 17 does not prescribe the approach to allow for the benefit/ impact of this sharing, different practical approaches are allowed. IFRS 17 does recognise that this practical approach may be at a higher level of aggregation than the individual groups of contracts. If this is the case, then a systematic and rational approach is used to allocate the effect of the change in underlying items to individual groups of contracts. Groups of contracts are still subject to the annual grouping requirement, just as contracts with no such sharing mechanism.

These fulfilment cash flows in a group of contracts may include payments expected to be made to current policyholders in other groups or to future policyholders. IFRS 17 does allow an approach where a liability for all such payments to be recognised and measured at an aggregate level with no allocation to specific groups (B71).

8.24. What are examples of situations in which cash flows in one group are impacted by cash flows in another group?

If profit sharing exists between two different groups, B69 explains the treatment. This is a very simple example. The first has a guarantee giving rise to fulfilment cashflows of 100.

The second actually supports this guarantee. Without supporting the guarantee its share of the underlying items would be 350. When it provides support to the other group the share falls to 250 (350 – 100). Under IFRS 17 the fulfilment cashflows of the group providing the support reflect the full 350 i.e., including the 100, and the other group, which receives the support, excludes the 100 in relation to the guaranteed amount. This may represent a change to current practise where guaranteed payments may be included in the group where they arise.

Mutual Insurance Companies

8.25. Are there any special rules for mutual insurance companies?

The precise nature of mutuals varies widely. For all mutuals, in some manner policyholders, or subsets of policyholders, will also own the company i.e., *"most of the residual interest of the entity is due to a policyholder and not a shareholder"* (BC265).

The treatment will depend on the exact facts and circumstances of the mutual in question.

Mutual insurers are, however, a specific case of mutualisation. Significant sharing exists between different groups of policyholders. In fact, policyholders, or a subset of policyholders will have rights to some, if not all, of the profits of the company.

This means that some policyholders will have two identities. The first a policyholder of the mutual insurer/entity, the second an owner of the mutual insurance company. These two roles are considered separately (B16).

Mutual insurers and the specific considerations for a mutual insurance company are considered further in the Basis for Conclusions (BC264 – BC269).

As some or all of the policyholders share in the residual interest, this means that residual interest payments to policyholders form part of the fulfilment cash flows regardless of whether those payments are expected to be made to current or future policyholders.

> *Thus, the fulfilment cash flows of an insurer that is a mutual entity generally include the rights of policyholders to the whole of any surplus of assets over liabilities. This means that, for an insurer that is a mutual entity, there should, in principle, normally be no equity remaining and no net comprehensive income reported in any accounting period (BC265)*

This can give rise to accounting mismatches between the measurement of insurance contracts, measured at current value using fair value information, and the measurement of other net assets, not required to be measured at fair value, of the mutual insurance company. The other assets may be required to be measured on a basis giving rise to a value lower than fair value (BC266).

This means that liabilities on the balance sheet may be higher than recognised assets, even though they are solvent for regulatory purposes and therefore are shown to have no equity rather than negative equity (BC267).

Comparability across the entire insurance industry is important, irrespective of the nature of the insurance entity. To allow for the specific nature of mutual insurers, under IFRS 17 those mutual insurers can distinguish between (BC269):

(a) in the statement of financial position, the liability attributable to policyholders in their capacity as policyholders from the liability attributable to policyholders with the most residual interest in the entity; and

(b in the statement(s) of financial performance, the income or expenses attributable to policyholders in their capacity as policyholders before determination of the amounts attributable to policyholders with the most residual interest in the entity.

8.26. When are any ownership rights of a policyholder in the mutual insurance company measured?

Ownership rights of a policyholder in a mutual insurance company may or may not be specifically measured depending on the jurisdiction, the type of company and the terms of a contract. The actuary may need to discuss the treatment to be used with his principal and the company's auditors to agree a treatment for the company.

8.27. Is it possible for a mutual insurance company to have equity?

This is a controversial question. In BC265 it is implied that the IASB believes that normally mutual insurers will have no equity. This statement is not guidance, however, and it leaves open the possibility for exceptions. Discussions in the industry have disagreed that there is no equity on a variety of grounds depending on, among other items, the exact terms of the contract and regulatory requirements to hold capital.

The OCI Option

8.28. What is the OCI option?

Under IFRS 17 the insurance finance income or expenses comprises the change in the carrying amount of the group of insurance contracts arising from (paragraph 87):

a. the effect of the time value of money and changes in the time value of money; and

b. the effect of financial risk and changes in financial risk; but

c. *excluding any such changes for groups of insurance contracts with direct participation features that would adjust the contractual service margin but do not do so when applying paragraphs 45(b)(ii), 45(b)(iii), 45(c)(ii) or 45(c)(iii). These are included in insurance service expenses.*

An entity can make an accounting policy choice between including the full amount of the insurance finance income or expense in P&L or disaggregating this amount between P&L and other comprehensive income (OCI) using a systematic allocation of the expected total insurance finance income or expenses over the duration of the group of contracts for contracts without direct participation features (paragraph 88).

For DPC the disaggregation is different. The disaggregation eliminates accounting mismatches with income or expenses included in profit or loss on the underlying items held (paragraph 89).

In both cases the balance of the amount included in P&L on disaggregation and the total amount of insurance finance income or expenses in the period is included in OCI (paragraph 90). The accounting policy choice as whether to disaggregate insurance finance income or expenses is made at the portfolio of insurance contracts level and is made in conjunction with an assessment of the treatment of the portfolio of assets (B129).

Changes in assumptions that relate to financial risk are included in insurance finance income or expenses. Inflation can be a financial or non-financial assumption. It depends on the nature of the inflation and how it is used (B128):

a. assumptions about inflation based on an index of prices or rates or on prices of assets with inflation-linked returns are assumptions that relate to financial risk; and

b. assumptions about inflation based on an entity's expectation of specific price changes are not assumptions that relate to financial risk.

8.29. How does the OCI option apply to DPCs?

If an entity chooses to disaggregate insurance finance income or expenses for DPCs in the P&L the insurance finance income or expenses on the liabilities is equal and opposite to the income or expenses included in profit or loss for the underlying items resulting in *"the net of the two separately presented items being nil"* (B134).

If contracts no longer qualify for direct participation in some periods then the amount accumulated in OCI is included as a reclassification adjustment in P&L (This is based on the amount previously included and is not recalculated for the approach now applying, or the new assumptions B136).

i. if the entity had previously applied paragraph 88(b)—the entity shall include in profit or loss the accumulated amount included in other comprehensive income before the change as if the entity were continuing the approach in paragraph 88(b) based on the assumptions that applied immediately before the change; and

ii. if the entity had previously applied paragraph 89(b)—the entity shall include in profit or loss the accumulated amount included in other comprehensive income before the change as if the entity were continuing the approach in paragraph 89(b) based on the assumptions that applied immediately before the change.

No restatement of prior periods is required (B135).

8.30. How does the OCI option apply for other participating contracts?

For contracts with discretionary features for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholder but which are not directly participating, the disaggregation is based on a systematic allocation of the

expected total finance income or expenses over the duration of the group of insurance contracts. The systematic allocation is based on characteristics of the contracts, without reference to factors that do not affect the cash flows expected to arise under the contracts i.e., if expected recognised returns on assets do not affect the cash flows of the contracts in the group, the impact of those returns is excluded (see B132(a)).

The systematic allocations are also such that over the duration of the groups of contracts that total amount recognised in OCI is zero. This means that when a contact matures the carrying amount of the group of contracts is equal to the amount measured using the systematic allocation (B130).

The systematic allocation of the future cashflows can be determined in one of two ways:

(i) using a rate that allocates the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate; or

(ii) for contracts that use a crediting rate to determine amounts due to the policyholders—using an allocation that is based on the amounts credited in the period and expected to be credited in future periods.

The effective yield approach is defined in the illustrative examples (IE 159):

> *Applying paragraph B132(a)(i), the entity uses a rate that allocates the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate (an 'effective yield approach'). The effective yield approach is not the same as the effective interest method as defined in IFRS 9 Financial Instruments.*

If the financial assumptions remain the same through the years (i.e., no changes related to future cash flows), the calculated effective yield will remain the same. However, if the financial assumptions change a revised effective yield will need to be calculated. The amount going through the insurance finance income/expense in the P&L will be calculated using this effective yield rather than the initial discount rate. The difference between this and the total impact will go through OCI.

The second of these is the crediting rate approach and is defined in the illustrative examples (IE 165):

> *Applying paragraph B132(a)(ii), the entity uses an allocation based on the amounts credited in the period and expected to be credited in future periods (a 'projected crediting rate approach'). In addition, applying paragraph B130(b), the entity needs to ensure that the allocation results in the amounts recognised in other comprehensive income over the duration of the group of contracts totalling to zero. In order to do so, the entity calculates a series of discount rates applicable to each reporting period which, when applied to the initial carrying amount of the liability equals the estimate of future cash flows. This series of discount rates is calculated by multiplying the expected crediting rates in each period by a constant factor (K).*

Using the crediting rate approach requires at least the following steps:

1. Calculate the fair value of liabilities on current assumptions (in our example they increase when interest rates fall).
2. Solve for rates which "amortise" the difference between the new value and the original estimate, in proportion to how interest is credited.
3. This scaling factor then scales the future outstanding crediting rates up through time. This results in the movements on the liability side closely matching the movements on the asset side.
4. In all cases the OCI balance must be re-spread when conditions change, so that the outstanding OCI balance at the end is zero.

For the risk adjustment, if the risk adjustment is also disaggregated, the systematic allocation used is consistent with the allocation of the future cashflows.

For the CSM, the systematic allocation uses the discount rate used to accrete interest (locked-in rate) (B132).

Presentation and Disclosures

8.31. Are there any differences with respect to presentation for DPCs?

There are no specific presentation requirements for DPCs. See chapter 15 for further details on presentation requirements.

8.32. Are there any additional disclosures required for DPCs?

For disclosures, an entity is required to explain the relationship between insurance finance income or expenses and the investment return on its assets (paragraph 110).

- The composition of the underlying items and their fair value is also disclosed (paragraph 111).
- If risk mitigation is used and the CSM is not adjusted for some changes in the fulfilment cashflows, the impact of this on the CSM is disclosed (paragraph 112).
- If the basis of disaggregation of insurance finance income or expenses is changed then the period when the change occurred, the reason, any adjustments as a result and the carrying amount of the contracts to which the change applied are disclosed (paragraph 113).

See also chapter 15

Chapter 9 – Reinsurance

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

9.A. What does this chapter address?

This chapter provides background and suggested practice on the treatment of reinsurance under IFRS 17. The note covers both reinsurance ceded (referred to as reinsurance "held" in IFRS 17) and reinsurance assumed (referred to as reinsurance "issued" in IFRS 17). As noted in paragraph 3, IFRS 17 is applicable to both reinsurance contracts held, and reinsurance contracts issued. For consistency with IFRS 17 terminology, reinsurance "held" and "issued" will be used in this note. Retrocession contracts are included in the definition of reinsurance contracts.

It is not applicable to reinsurance contracts that are considered to be financial instruments under IFRS.

9.B. Which sections of IFRS 17 address this topic?

As noted in paragraph 4, all references in IFRS 17 that refer to insurance contracts also apply to reinsurance contracts held unless otherwise indicated by specific reference to reinsurance issued or as specified in paragraphs 66-70 for reinsurance held.

9.C. What other IAA documents are relevant to this topic?

None

9.1. When is IFRS 17 used to account for reinsurance contracts?

A reinsurance contract is an insurance contract where one entity (the reinsurer) takes on all or part of the insurance risks issued by another entity. When an entity sends risks to another entity it is known as reinsurance ceded. When an entity receives risks from another entity it is known as reinsurance assumed. Where there is significant insurance risk transfer, the reinsurance contract is considered as an insurance contract under IFRS, and IFRS 17 is applicable (paragraph 3). This applies to both reinsurance held (the IFRS 17 terminology for a reinsurance ceded contract) and reinsurance issued (the IFRS 17 terminology for a reinsurance assumed contract).

IFRS outlines the criteria to determine whether there is significant insurance risk transfer under the contract (see question 9.2 below). Where a contract fails these criteria, IFRS 17 does not apply, and the reinsurance is treated as a financial instrument.

9.2. What constitutes significant insurance risk transfer for reinsurance?

To determine if IFRS 17 is applicable, for each reinsurance transaction that a company has in place, an assessment needs to be made as to whether there is significant insurance risk transfer under the contract. The criteria are covered in detail in paragraphs B7-B23. See chapter 1 – Classification of contracts.

Under IFRS, an insurance contract is one under which one party accepts significant insurance risk, other than financial risk, from another party by agreeing to compensate the other party if a specified uncertain future event (the insured event) adversely affects the other party.

Under IFRS, *the insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (i.e., no discernible effect on the economics of the transaction)*. IFRS specifically says this condition may be met even if the insured event is extremely unlikely or even if the expected (i.e., probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows.

For reinsurance, there are two specific exceptions to the above general principles:

- Lapse, persistency or expense risk would not normally meet the criteria for insurance risk outlined above as, under paragraph B15, *because the resulting variability in the payment to the policyholder is not contingent on an uncertain future event that adversely affects the policyholder*. However, where risk that does not adversely affect the policyholder is mitigated by an entity by using a second contract to transfer some of all of these risks to another party, that party is exposed to insurance risk (paragraph B15). Therefore, a reinsurance contract that satisfies this criterion meets the definition of an insurance contract and hence is a reinsurance contract under IFRS 17 and should be recognised and measured as reinsurance issued and reinsurance held for the respective party.
- Even if a reinsurance contract does not expose the issuer of the contract to the possibility of a significant insurance loss, the contract is still deemed to transfer significant insurance risk if it transfers substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts (paragraph B19). Therefore, a reinsurance contract that meets this criteria can be considered as insurance contracts for both the entity issuing the contract and the entity that holds the reinsurance.

The Balance of This Chapter is Applicable Only to Reinsurance Classified as Insurance Contracts Under IFRS

Reinsurance Held – (Questions 9.3 – 9.16)

9.3. How is reinsurance held presented in the IFRS statement of financial position and statement of financial performance?

Where an entity has entered into reinsurance contracts to cede insurance risk associated with underlying insurance contracts (either direct insurance contracts or reinsurance contracts issued), the reinsurance held contracts are recognised and presented on the balance sheet as groupings of reinsurance contracts held that are assets and groupings of reinsurance contracts held that are liabilities. This means that for the statement of financial position, the reinsurance held is shown separately from the underlying insurance

contracts (paragraph 78). Similarly, for the statement of financial performance, the income and expense from reinsurance held are shown separately from the expenses and income of the underlying insurance contracts (paragraph 82).

9.4. Does reinsuring insurance contracts impact the recognition of the underlying insurance contacts?

No. Reinsurance does not impact the recognition of the underlying insurance contracts. As per paragraph 75, "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".

9.5. Does reinsuring insurance contracts impact the measurement of the underlying insurance contracts on the IFRS balance sheet?

No under IFRS 17, the valuation of insurance contracts issued by an entity is not impacted by entering into reinsurance contracts to mitigate risks in the contracts issued. The insurance contracts continue to be valued on a gross basis. Therefore, the estimates of future cash flows of a group of underlying insurance contracts would usually be the same regardless of whether there is reinsurance held associated with these obligations. This also applies to the entirety of the fulfilment cash flows, including the risk adjustment for non- financial risk, and the CSM.

It should be noted that an entity's approach to diversifying its risk exposure, including potential use of reinsurance, may impact the gross risk adjustment. However, this would be an indirect impact based on the entity's approach to using reinsurance generally to diversify risk, and not reflect a direct linkage for a specific reinsurance held treaty.

9.6. How are reinsurance contracts held measured?

The measurement of reinsurance held is represented by the fulfilment cash flows associated with the reinsurance held contract plus a CSM. The measurement value is separately determined from the valuation of the fulfilment cash flows and CSM of the underlying gross insurance liabilities. See also questions 9.9 and 9.10.

While the valuation measurement follows the same general measurement approach as for insurance contracts generally, there are some key differences in the methodology.

With respect to the estimate of future cash flows, paragraph 63 requires consistency between the assumptions used in the measurement of the reinsurance contracts held and in the measurement of the underlying gross insurance liabilities (see question 9.9).

With respect to the risk adjustment, a different definition of the risk adjustment is used for reinsurance held that replaces the general definition used for insurance contracts (see question 9.9)

With respect to the CSM, there are specific additional considerations for reinsurance contracts held (see question 9.7).

9.7. Does the asset or liability for reinsurance held have a CSM?

Assuming the PAA is not being used, a CSM is determined for reinsurance contracts held using a similar approach as for other insurance contracts. However, there is a key difference in that the CSM can both reduce the reinsurance held asset (i.e., present value of reimbursements from the reinsurance contract exceed the present value of reinsurance premiums) and therefore defer recognition of profit from the reinsurance contract, or increase the reinsurance held asset (i.e., present value of reinsurance premiums exceeds the present value of reimbursements from the reinsurance contract) and therefore defer recognition of losses from the reinsurance contract.

This means that the concept of an 'onerous' reinsurance held contract does not exist (see paragraphs 29 (b), 61 and 65). The rationale is that a net loss from the reinsurance contract would usually represent a commercial expense of purchasing reinsurance and would normally be spread over the period in which the service is received.

However, where there is a change in the fulfilment cash flows of a group of underlying insurance contracts that does not adjust the CSM for this group, the insurer similarly does not adjust the CSM on the reinsurance held asset for changes in fulfilment cash flows associated with these same underlying insurance contracts (see paragraph 66 (c) (ii)). This applies only for subsequent measurement, not for initial measurement.

This means that where an entity has transferred risk to a reinsurer, there is an attempt for subsequent measurement to create consistency in how changes in the fulfilment cash flows associated with the risks transferred is treated in the CSM of the reinsurance held and the gross insurance liabilities. However, there is no attempt to create similar consistency at initial measurement.

9.8. Would the future cash flow assumptions for business covered by reinsurance held be the same as the future cash flow assumptions used for the same business in the underlying insurance contract valuation?

Paragraph 63 states that *"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."* This means that assumptions related to policyholder behaviour or insured decrements (e.g., mortality rates, morbidity rates, policyholder claims assumptions) would be consistent between the underlying insurance contract valuation and where these assumptions are used to help determine the value of the reinsurance held. Other assumptions, such as expenses may be different.

In addition, other variables and determinants of the cash flows, including the contract boundary, may be different depending on the terms of the reinsurance. See also question 9.11.

9.9. How is the reinsurance held risk adjustment for non-financial risk determined?

A specific definition for the determination of the risk adjustment for reinsurance contracts held is provided that replaces the general definition in paragraph 37 used for

insurance and reinsurance contracts issued in the standard. Under the definition for reinsurance held, the quantum of the risk adjustment for non-financial risk represents the amount of risk being transferred by the holder of a group of reinsurance contracts to the issuer of those contracts (paragraph 64).

The risk adjustment for the reinsurance held can therefore conceptually be thought of as the difference in the risk position of the entity with (i.e., net position) and without (i.e., gross position) the reinsurance held. As a result, the appropriate risk adjustment for the reinsurance held could be determined based on the difference between these amounts.

For reinsurance held, because the risk adjustment for reinsurance held is defined based on the amount of risk transferred to the reinsurer, the risk adjustment for reinsurance held will normally create an asset. On this basis, where a reinsurance contract held is reported as an asset the risk adjustment will have the effect of increasing the value of the asset, and will decrease the liability value where the reinsurance contract held is reported as a liability.

9.10. How is counter party risk of non-performance by the issuer of reinsurance contracts reflected in reinsurance contracts held?

In determining the fulfillment cash flows, the estimates of future cash flows to be received for the reinsurance contracts held are reduced by an allowance for reinsurance counter party failure to fulfill the contractual obligations (paragraph 63). This allowance would reflect not only potential reinsurance counter party failure due to defaults (i.e., credit events), but would include allowances for disputes resulting in reduced payments as well reflecting the effects of collateral. Default allowances would normally reflect the current financial condition and credit standing of the reinsurance counter party, as well as the potential for these conditions to change over time. If the allowance for non-performance in the fulfillment cash flows is changed, then the change does not adjust the contractual service margin (paragraph 67).

With respect to the risk adjustment, the requirement in paragraph 64 that the risk adjustment for non-financial risk represents the amount of risk being transferred by the entity to the reinsurer has been interpreted two ways with respect to non-performance risk. One interpretation is that counter party risk is not considered in the risk adjustment as this is not a risk formally transferred by the contract. An alternative interpretation that has been put forward is that counter party risk is appropriate to consider in the risk adjustment since this is a risk that, at an entity level, exists for the party with the reinsurance held as a result of entering the contract to transfer risk.

9.11. Would grouping of business for reinsurance held be the same as contract grouping used for the same business in the gross insurance liabilities?

The grouping for business covered by reinsurance held may be different than the contract grouping for the same underlying business in the gross insurance liabilities.

Under IFRS 17, contracts are normally grouped, although it is permissible to have one contract in a group. In addition, the general approach is that unless a contract contains

components that would be within the scope of another standard if they were separate contracts, the contract is contemplated as the most basic unit of account.

A reinsurance contract is a single contract, even though it may consist of cessions of many underlying insurance contracts.

Because certain reinsurance contracts already aggregate risk and consolidate underlying contract exposures, it may in some circumstances make sense to make use of the permission to have one (reinsurance) contract in a group.

The grouping requirements for insurance contracts outlined in paragraphs 14 – 24 also apply for reinsurance, with the exception that for reinsurance contract held there is an additional paragraph, 61, to account for the fact that reinsurance contracts cannot be onerous. Paragraph 61 states that "*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*".

9.12. What are the considerations when a reinsurance held contract may cover multiple years of underlying insurance contracts or risk attachments?

For reinsurance held, a single reinsurance held contract may cover multiple years of underlying contract cessions or risk attachments. Some reinsurance held contracts, in addition to covering existing risks/cessions, are open to accepting future cessions/risk attachments. This leads to the question when measuring the value of an existing group of reinsurance held contracts at a point of time T, what future cessions/risk attachments after time T are reflected in the modeling of the future cash flows in the fulfillment cash flows.

There are several relevant paragraphs in the standard.

Paragraph 33 states that "*An entity shall include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group*".

Paragraph 34 states that "*Cash flows are within the boundary of an insurance contract 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 insurance contracts 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".

The above wording in paragraph 34 is written from the perspective of a directly written insurance contract and must be interpreted for reinsurance held contracts. An interpretation that has been put forward for reinsurance contracts held is that cash flows are within the contract boundary for a reinsurance held contract if they arise from substantive rights and obligations that exist during the reporting period in which the ceding entity is compelled to pay amounts to the reinsurer or in which the entity has a substantive right to receive services from the reinsurer.

The implications of the above paragraphs in the standard might best be given by examples.

Consider 2 possible non-proportionate reinsurance held contracts each, for the sake of simplicity, considered a separate "group" of 1 contract.

Contract A is a reinsurance contract held where existing risks are covered until they expire at guaranteed rates. The treaty is open to new risk attachments but the reinsurer and cedent can terminate the treaty accepting new risks at any time.

The implication is that at any valuation date T that falls within the contract boundary, the insurer would project future cash flows related to the existing risk attachments at time T, and would not project future risk attachments since there is no contractual obligation from either party to continue to accept new risks into the treaty. At time T+1, the cash flows of the reinsurance contract held would include the projections of cash flows for all risk attachments up to time T+1 (i.e., risks that attach between T and T+1 would be included and reflected as changes in estimates of the fulfillment cash flows).

Contract B is a reinsurance contract held where existing risks are covered until they expire at guaranteed rates. The treaty is open to new risks at guaranteed rates for at least the next 3 years, after which the reinsurer can terminate accepting new risks.

The implication is that at any valuation date T that falls within the contract boundary, the insurer would project future cash flows related to the existing risk attachments at time T, and would also project future risk attachments for risks for the next three years because the reinsurer has contractually agreed to accept those risks by locking in guaranteed rates. At time T+1, the cash flows of the reinsurance contract held would include the projections of cash flows for all risk attachments up to time T+1, including true up of cash flows for actual versus expected for risk attachments between T and T + 1, plus updated projected cash flows for future risk attachments for the next two years.

There are other implications to be considered.

- The future cash flows included may impact the ability to use the PAA. Where a reinsurance contract is intended to cover multiple years of cessions/risk attachments, it may prove more difficult to prove eligibility to apply the PAA for contracts where the coverage period for the underlying contract is only one year, but new risks attach after the inception date.

- The IFRS 17 application guidance states that, when determining the discount rates for initial recognition, "*an entity may use weighted-average discount rates over the period that contracts in the group are issued, which applying paragraph 22 cannot exceed one year*" [paragraph B73]. When a reinsurance contract covers multiple cession years and all cession years are considered as part of the same contract for purposes, the interpretation that discount rates may only take into account interest rates during the initial year that a contract is in-force may produce an economic mismatch when a reinsurance contract is open for multiple years and new cessions are added in subsequent years after the initial contract year.
- There are additional considerations related to the cash flows to include in the modelling for proportionate reinsurance contracts (see question 9.13).

9.13. Are there special considerations for the initial recognition of proportionate reinsurance held?

There are additional considerations related to proportionate reinsurance held contracts.

Paragraph 62 states that "*Instead of applying paragraph 25, an entity shall recognize 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 later; and (b) in all other cases – from the beginning of the coverage period of the group of reinsurance contracts held.*"

Two views on the meaning of Paragraph 62(a) for proportionate reinsurance have been put forward. The first interpretation is that the additional consideration that there is no recognition until at least the first underlying contract is recognised applies only to the initial recognition of the group of reinsurance held contracts. It does not impact which cash flows are modeled once the group of reinsurance held contracts is initially recognised – that is, all future cash flows expected to be within the contract boundary are modeled regardless of whether the underlying contracts have been recognised. The second interpretation assumes that this additional consideration is broader and means that only cash flows associated with underlying contracts that have been recognised are modeled (i.e., future cash flows associated with underlying cessions that have not yet been recognised are not modeled).

Under paragraph 62(b), for non-proportionate reinsurance all future cash flows expected to be within the contract boundary are modeled without reference to the status of underlying contracts.

9.14. What is a proportionate reinsurance coverage?

Proportionate reinsurance is not a defined term in IFRS 17. In the Basis for conclusions, which is not a part of the standard, there is a reference to the distinction between proportionate versus non-proportionate reinsurance [paragraph BC304]. "*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".

9.15. Can the PAA be used for reinsurance contracts held?

Yes, reinsurance contracts held are eligible for the PAA provided they meet the criteria to use the approach (paragraph 69). The criteria to use the PAA, such as coverage period of the contracts in the group, need to reflect the contractual terms of the reinsurance contracts held in the group, and not the underlying insurance contracts.

9.16. Are there potential economic mismatches between the measurement of a reinsurance contract held and the measurement of associated underlying insurance?

There are several areas of possible economic mismatch.

For reinsurance contracts held, the contract boundary definition means that the measurement of reinsurance contracts held will typically extend to include cash flows associated with future projected cessions up to the point at which the reinsurance contract can be exited for new business. The valuation of underlying insurance contracts will not include any cash flows related to these future projected cessions, since the underlying insurance contracts are only valued as written. This creates a mismatch in terms of timing of recognition of cessions versus underlying contracts.

For underlying contracts, losses are recognised at inception when contracts are onerous at inception, whereas any offsetting net gain on related reinsurance contracts held will be reflected in the CSM and recognised over the lifetime of the reinsurance contract held. This can create a mismatch in terms of timing of profit and loss on contracts that may be economically linked (e.g., pricing of underlying contracts frequently reflects impact of associated reinsurance, particularly for proportionate coverages).

Underlying contracts may use the variable fee approach, while associated reinsurance held contracts are not eligible to use the variable fee approach. This can create measurement mismatches due to significant differences in treatment of investment related impacts.

Reinsurance Held and Reinsurance Issued (Questions 9.17 – 9.20)

9.17. Would the contract boundary used for reinsurance issued and reinsurance held for the same contract necessarily be the same?

The contract boundary would normally be the same for both parties. This is because the contract boundary is determined by looking at the substantive rights and obligations of both parties to the contract.

9.18. How are contractual options such as recapture, cancellation, or commutation treated in developing reinsurance cash flows?

The cash flows would reflect characteristics of the reinsurance contract. Reinsurance treaties may contain options that may be exercised at the discretion of the party holding or issuing the contract. The cash flows might assume that the entities issuing and holding the reinsurance contract each exercises its control over such options to its advantage

taking into account any other considerations with respect to expected behaviour. Advantage would be determined based on the assumptions used in the valuation.

9.19. Can reinsurance contracts qualify as insurance contracts with direct participation features?

Reinsurance contracts, including both reinsurance held and reinsurance issued cannot qualify as insurance contracts with direct participation features (paragraph B109). Therefore, they cannot use the CSM approach outlined for contracts with direct participation features.

9.20. How should continuation of a reinsurance contract past a contract boundary be treated?

Under IFRS 17, two fundamentally different approaches have been put forward for the situation where a reinsurance contract with a contract boundary is extended beyond the original boundary through the exercise of contractual terms – for example, continuation of a fully cancellable reinsurance treaty with guaranteed premiums past the cancellation exercise date which created the boundary. Under one approach, the continuation would extend the contract boundary of the original contract and the impact reflected as changes in the fulfillment cash flows of the contract. Under the second approach, the continuation would be treated as a new contract with a new contract boundary.

The treatment as a change in fulfillment cash flows of an existing contract is based on the following considerations:

- It is consistent with Paragraph B64 which states that *"in determining the estimates of future cash flows at the end of a reporting period, an entity shall reassess the boundary of an insurance contract to include the effect of changes in circumstances on the entity's substantive rights and obligations"*.
- It is consistent with the approach outlined in paragraphs 72 and 73 for treatment of various forms of contract modifications. Under these paragraphs, such renewal impacts would not meet the threshold for recognition of a new contract and would be considered as changes in the estimates of fulfillment cash flows. Interpretation is based on the modification and de recognition paragraphs 72 and 73. Under paragraphs 72, there is the statement that "*the exercise of a right included in the terms of a contract is not a modification"*. As such, changes in cash flows due to exercise of contractual rights would be considered as changes in the estimates of fulfillment cash flows by applying paragraphs 40-52 and not a new contract event.
- While paragraph 35 states that *"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 insurance contract. Such amounts relate to future insurance contracts",* this requirement is interpreted to mean that such cash flows are not currently considered, but such assessment is not permanent and can change as substantive rights and obligations change.

The treatment as a new contract is based on a stricter interpretation of the paragraph 35 statement that *"an entity shall not recognize as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. Such amounts relate to future insurance contracts".*

Reinsurance Issued (Questions 9.21 – 9.23)

9.21. How is reinsurance issued presented on the IFRS balance sheet?

Where an entity has entered into reinsurance contracts to assume risk and obligations, the value of these contracts is shown on the balance sheet as part of the insurance liabilities or assets, with contracts grouped into those that are assets, and those that are liabilities.

9.22. Are there special considerations for reinsurance issued liabilities?

In general, reinsurance issued business, once classified as insurance risk, is treated consistently in approach with all other gross insurance liabilities issued.

Data issues are frequently more prevalent for reinsurance issued business, particularly life reinsurance, than for underlying insurance business, as the reinsuring entity is further removed from the underlying risks than the ceding entity, and is reliant on the entity company for underlying data on insured risks. This means that there is frequently more use of approximations both in terms of data and modeling approach. It is important that actuaries performing valuations of reinsurance issued business understand the impact of approximations made and be able to assess their reasonableness.

9.23. What are the considerations when a reinsurance issued contract may cover multiple years of underlying insurance contracts or risk attachments?

For reinsurance issued, a single reinsurance held contract might cover multiple years of underlying contract cessions or risk attachments, so that in addition to covering existing risks/cessions, treaties might be open to accepting future cessions/risk attachments.

This leads to the question, when measuring the value of an existing group of reinsurance issued contracts at a point of time T, what future cessions/risk attachments after time T should be reflected in the modeling of the future cash flows in the fulfillment cash flows.

The considerations and relevant paragraphs in the standard are similar to reinsurance held as covered in question 9.12.

Other Questions

9.24. What additional explanations and disclosures may be included in the actuary's report related to reinsurance?

The objective of additional disclosure requirements is to enable the Board and management to better understand the way in which the actuary has undertaken his or her work. Key elements of this related to reinsurance, may include:

- discussion of the impact of reinsurance as part of risk mitigation considerations to determine the company's risk profile;

- discussion of any uncertainty in relation to recoverability of reinsured amounts;
- discussion of the insurer's net risk profile and how this is appropriately reflected as the difference between the gross and reinsurance risk adjustments.

Section C – Uses of fair value measurement in IFRS 17

This section considers the use of the fair value measurement of insurance contracts for IFRS 17 including for business combinations or portfolio transfers and on transition if the fair value approach is chosen. This section comprises three chapters:

- Fair Value – Chapter 10
- Business Combinations and Portfolio Transfers – Chapter 11
- Transition – Chapter 12

Chapter 10 discusses the principles of how to determine the fair value of insurance contracts in the context of the more general guidance on fair value measurement found in IFRS 13 *Fair Value Measurement* and of common insurance industry practices.

Chapter 11 discusses the requirements under IFRS 17 when accounting for insurance contracts or liabilities for incurred claims acquired in a business combination or a portfolio transfer, and in particular the need to use the fair value of the contracts as the initial consideration.

Chapter 12 discusses the one-time event of presenting statements applying IFRS 17 for the first time a section for each of the three transition approaches described in IFRS 17 – the retrospective approach of IAS 8 and the alternative approaches introduced by IFRS 17, modified retrospective and fair value.

Chapter 10 – Fair Value

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

10.A. What does this chapter address?

This chapter considers the fair value measurement of contracts in IFRS 17 in the context of the more general guidance on fair value measurement found in IFRS 13 *Fair Value Measurement* and of common insurance industry practices.

10.B. Which sections of IFRS 17 address this topic?

Paragraphs 39 and B94 specify the use of fair value when contracts are acquired in a business combination. Paragraphs C5 and C20-24 discuss the use of fair value on transition to IFRS 17.

10.C. What other IAA documents are relevant to this topic?

Chapter 12 *Transition*.

10.1. When is fair value measurement applied to insurance contracts[17]?

In IFRS 17, fair value measurement is used:

(a) at initial recognition of contracts acquired in a business combination. The fair value is determined as of the date of the acquisition. See chapter 11, and

(b) on transition to IFRS 17 when the fair value approach (paragraph C5b) is selected. The fair value is determined as at the transition date, which is usually the beginning of the period immediately preceding the date of initial application of IFRS 17. See chapter 12.

For insurance contracts acquired in a business combination, IFRS 17 states that the fair value of the contracts is the consideration received for those contracts (paragraph B94). Business combinations may include other assets and liabilities, in which case the consideration received for the insurance contracts needs to be determined separately from other assets and liabilities acquired, and may exclude certain factors that might be considered in a business combination (see question 10.4).

This chapter addresses fair value measurement in the context of business combinations where the consideration received for the insurance contracts is estimated and in the context of transition to IFRS 17. This chapter may also be useful in the context of contracts acquired in a transaction that does not form a business combination where the fair value of groups of contracts is used to allocate the total consideration for the entire block of contracts to the groups.

[17] The term "insurance contracts" as used in this chapter includes all contracts in the scope of IFRS 17.

Fair value measurement is also used to measure embedded derivatives that are separated from insurance contracts and for financial instruments issued by insurers, which are not in the scope of IFRS 17. These applications of fair value measurement are not addressed in this chapter.

10.2. What is the fair value of insurance contracts?

IFRS 17 does not provide guidance on determining the fair value of insurance contracts, except as noted below in relation to a demand deposit floor. IFRS 13 *Fair Value Measurement* provides guidance when other IFRSs require fair value measurement, with certain exceptions. Insurance contracts are not specifically excluded from the scope of IFRS 13, and consequently IFRS 13 is relevant to insurance contracts. IFRS 13 does not provide specific guidance on insurance contracts; hence the entity is left to consider how to apply the guidance in IFRS 13 to insurance contracts.

IFRS 13 defines fair value as:

> *"…the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." (paragraph 9 of IFRS 13)*

A comprehensive discussion of IFRS 13 is beyond the scope of this chapter. What follows are the relevant considerations of IFRS 13 as they apply to insurance contracts.

IFRS 13 Fair Value Measurement IFRS 13 requirement	Application to insurance contracts
The price may be observable but if it is not, it must be estimated (paragraph 2 of IFRS 13).	Prices for insurance contracts are rarely observable. In most cases the fair value of insurance contracts needs to be estimated. See question 10.3.
Fair value is a market-based measurement, not an entity-specific measurement (paragraph 2 of IFRS13). Fair value should be measured using the assumptions that market participants would use (paragraph 22 of IFRS 13).	Measurement from the perspective of a market participant may be different from the measurement of fulfilment cash flows (paragraph 57 of IFRS 13). See questions 10.4 and 10.5.
The objective is to estimate the price under current market conditions (paragraph 2 of IFRS 13).	Current market conditions refer not only to general economic conditions (e.g., interest rates) but also to the state of the market for transfers of insurance

IFRS 13 Fair Value Measurement	
IFRS 13 requirement	Application to insurance contracts
	contracts, which may be difficult to determine. See question 10.4.
The price is based on a hypothetical transaction in the principal market or, if there is no principal market, in the most advantageous market (paragraph 16 of IFRS 13).	The distinction between the principal market and the most advantageous market for insurance contracts may not make a difference. Market participants are likely to be limited to other insurers or reinsurers that would be able to complete a transaction.
The unit of account is determined in accordance with IFRS 17 (paragraph 14 of IFRS 13) and is the level at which an asset or a liability is aggregated or disaggregated for recognition purposes (IFRS 13 Appendix A).	In IFRS 17, the unit of account for recognition and measurement of the liability is *groups* of insurance contracts, as that is described in the standard (see also chapter 5). The fair value would similarly be measured by *groups* of insurance contracts.
When a price for a liability is not available and the identical item is held by another party as an asset, fair value is measured from the perspective of market participant that holds the asset (paragraph 37 of IFRS 13).	For this purpose, policy owners are not considered to be market participants. Furthermore, the price associated with a viatical settlement would not be relevant to the measurement of fair value of a group of insurance contracts.
Non-performance risk, (which includes consideration of credit standing) is reflected in the fair value measurement of a liability (paragraph 42 of IFRS 13).	Fair value measurement reflects non-performance risk of the entity, however, the measurement of fulfilment cash flows under IFRS 17 does not. See question 10.5.
There is a demand deposit floor on the fair value of financial liabilities (paragraph 47 of IFRS 13).	IFRS 17 states that a demand deposit floor does not apply when the fair value of insurance contracts is determined (paragraph B94 (business combinations) and C20 (transition)). See question 10.5.

IFRS 13 Fair Value Measurement	
IFRS 13 requirement	Application to insurance contracts
When price is not observable, the entity measures fair value using another valuation technique that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs (paragraph 3 of IFRS 13). An entity shall use valuation techniques consistent with one or more of the market approach, the cost approach and the income approach to measure fair value (paragraph 62 of IFRS 13).	Actuarial valuation techniques such as embedded values, actuarial appraisals and other present values techniques appear to be consistent with the income approach to measure fair value (paragraph B19 of IFRS 13), but may need to be adapted for the purpose of IFRS 17. See questions 10.5 and 10.6.
IFRS 13 has a hierarchy of inputs to valuation techniques used to measure fair value (paragraphs 72-90 of IFRS 13): • Level 1: Observable quoted prices, in active markets. • Level 2: Quoted prices are not available, but the input is based on observable market data. • Level 3: Unobservable inputs. The asset or liability being measured is characterized by the highest input level.	Fair value measurement of insurance contracts would usually require Level 3 inputs, especially with respect to non-market variables, and hence are likely to be characterized as Level 3.
IFRS 13 has a number of disclosure requirements related to fair value measurement after initial recognition (paragraphs 91-99 of IFRS 13).	Fair value measurement of insurance contracts only takes place at an initial date (acquisition date or date of first reporting on transition), and therefore the disclosure requirements of paragraphs 91-99 of IFRS 13 may have limited applicability.

10.3. How is the fair value of insurance contracts calculated?

IFRS 13 does not prescribe a valuation technique. In the context of a business combination, the entity may have an analysis of value that can form the basis of the fair value measurement, perhaps requiring adjustment to be consistent with the objective of an exit price.

The application guidance in Appendix B of IFRS 13 provides information about other possible valuation techniques. Among them are present value techniques (paragraphs B12-B30 of IFRS 13) for the fair value measurement of a stream of cash flows. These techniques share many characteristics with the IFRS 17 guidance on measuring fulfilment cash flows (e.g., paragraph B23 of IFRS 13) and therefore are candidates for the estimation of fair value of insurance contracts under IFRS 17.

An approach to estimating fair value of a group of insurance contracts using a present value technique is to adjust the fulfilment cash flows of the group of insurance contracts in order to fulfil the objectives of IFRS 13. Adjustments to reflect the perspective of market participants (i.e., to move to an exit price) are discussed in question 10.5.

IFRS 13 does not specify that a fair value estimate be before-tax or after-tax. However, there is a general admonition that valuations should be internally consistent, with specific mention that this general principle means that after-tax cash flows are discounted with an after-tax rate, and pre-tax cash flows are discounted with a pre-tax rate.

10.4. How would IFRS 13 Level 1 and 2 inputs (observable market information) be applied?

Market transactions involving insurance contracts may provide information about fair value, and the estimated fair value should be consistent with observable market information where available. However, it is unlikely that a direct relevant market price would be found. Furthermore, the transaction price at which a group of insurance contracts is exchanged may include factors (such as those in paragraph B4 of IFRS 13) that would be ignored for the purpose of estimating the fair value of a group of insurance contracts. Factors specific to insurance contracts that would be ignored include, for example:

- Expected profits/losses associated with cash flows beyond the boundaries of the insurance contracts,
- Expected profits/losses associated with investment/service components that will be recognized and measured separately from the group of insurance contracts, and
- Expense, tax or other synergies that a particular market participant might expect to realize, but that would not be generally available in the principal market.

Information that would be relevant, if reasonably available, might include:

- Market view of expected expenses associated with fulfilling the obligations of the insurance contracts in the group,
- Market view of the cost of risk associated with taking on the obligations of the insurance contracts in the group, and
- Market view of the cost of reinsurance that would be required to take on the obligations of the insurance contracts in the group.

IFRS 13 requires the entity to maximize the use of relevant observable inputs (paragraphs 3, 36, 61 & 67 of IFRS 13). However, an entity need not undertake exhaustive efforts to

obtain information about market participant assumptions and may use information that is reasonably available (paragraph 89 of IFRS 13).

10.5. When using a present value approach, what adjustments would be made to fulfilment cash flows to satisfy the objectives of fair value measurement?

When using a present value approach, the fair value of a group of insurance contracts can be seen as the fulfilment cash flows adjusted to take into account the perspective of market participants (i.e., move to an exit price).

Possible adjustments that could be made include the following:

- The discount rates applied to the estimates of future cash flows (paragraph B14c of IFRS 13) are increased to reflect the entity's own credit risk (paragraph B13f of IFRS 13).
- Where consistent with market practice, the discount rates applied to the estimates of future cash flows are adjusted to reflect the perspective of market participants on the liquidity characteristics of the group of insurance contracts.
- Where different from the entity's view, projected expense cash flows reflect the market view of the expenses associated with fulfilling the obligations of the group of insurance contracts. For example, where consistent with market practice, expense cash flows are increased to cover a reasonable level of general expenses (i.e., expenses not directly attributed to the portfolio to which the group of insurance contracts belongs).
- Where different from the entity's view, other assumptions used in cash flow projections are adjusted to reflect the market view. For most assumptions, the market view is likely to be the same as the entity's view because the entity has the best information available and the fulfilment cash flows take into account all relevant available information. However, for assumptions that are not specific to the entity or its contracts (e.g., future population mortality improvement), the market view might differ from the entity's view.
- Where different from the entity's view, the risk adjustment for non-financial risk is adjusted to reflect a degree of risk aversion (paragraph B83b of IFRS 17) consistent with the market view.
- Where different from the entity's view, the degree of diversification benefit (paragraph B83a of IFRS 17) included in the risk adjustment for non-financial risk is adjusted to be consistent with the market view. As noted in question 10.2, the unit of account for fair value measurement under IFRS 17 is *group* of insurance contracts.
- Where consistent with market practice (and where not otherwise reflected in the estimate of fair value), the risk adjustment is increased to include the cost of capital or risks not covered in the fulfilment cash flows.

- Where consistent with market practice (and where not otherwise reflected in the estimate of fair value), the fair value is decreased to reflect expense, tax, or other synergies that would be available in the principal market.
- Where not included in the other points above, the return that a market participant would require for undertaking the activity (see paragraph IFRS 13.41 and B31), which could be interpreted to include profit margins that a third party would require for providing services attached to the contract.

10.6. How do embedded values or appraisal values compare to fair values?

Embedded values or appraisal values are typically determined in the context of a transfer of liabilities together with supporting assets, and consider the present value of future expected profits less the cost of capital.

The fair value of insurance contracts under IFRS 17 is the fair value of the liabilities only, i.e., ignoring the supporting assets. Therefore, embedded/appraisal values will not be directly relevant to fair value measurement under IFRS 17 because they measure the profit expected from liabilities together with assets rather than the amount of assets that would be required to take over the obligations (liabilities) of the contracts.

However, embedded/appraisal value calculations might provide some context to help assess the market view of the degree of risk aversion, cost of capital, or other factors affecting fair value measurement (see question 10.5). For example, a high hurdle rate for the present value of future profits is likely to suggest a high cost of capital.

10.7. Can a group of insurance contracts be onerous on acquisition?

A group of insurance contracts would be onerous if the fair value is less than the fulfilment cash flows. This may be unusual under the present value approach described in this chapter, as most of the adjustments noted in question 10.5 contribute to the fair value being higher than fulfilment cash flows. However, there may be circumstances in which market conditions conspire to make the fair value less than the fulfilment cash flows, so this possibility would not be disregarded.

10.8. Are there any special considerations for estimating the fair value of insurance contracts with direct or indirect participation features?

The general approach is the same as for contracts without participation features. Adjustments made to fulfilment cash flows (question 10.5) would reflect the participation features of the insurance contracts. In particular, if discount rates applied to cash flows that vary based on the returns on underlying items have been adjusted to reflect that variability (paragraph B74b), the discount rates used for fair value measurement would be similarly adjusted.

Alternatively (equivalently), the fair value of a group of insurance contracts could be estimated as the fair value of the groups' share of the underlying items with adjustments as needed to account for the non-participating features of the contracts in the group.

10.9. Are there any special considerations for estimating the fair value of reinsurance contracts?

The general approach is the same as for direct written contracts. The market for reinsurance contracts would be related to the market for the contracts that are reinsured, as transactions involving reinsurance contracts are usually part of transactions involving the reinsured contracts. With this perspective, the fair value of a group of reinsurance contracts can be viewed as the amount that brings the fair value of the reinsured (underlying direct) contracts to the net fair value of the direct contracts combined with the reinsurance contracts. In other words, the fair value of a group of reinsurance contracts is the difference between the fair value of the underlying direct contracts (ignoring reinsurance) and the fair value of the underlying direct contracts combined with the reinsurance contracts.

Chapter 11 – Business Combinations and Portfolio Transfers

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

11.A. What does this chapter address?

This chapter considers the requirements under IFRS 17 when accounting for insurance contracts or liabilities for incurred claims acquired in a business combination or a portfolio transfer, and in particular the need to use the fair value of the contracts as the initial consideration. This chapter considers the interaction between IFRS 17 and the more general guidance found in IFRS 3 *Business Combinations* and discusses aspects of business combinations, such as the determination of goodwill and the recognition of intangible assets

11.B. Which sections of IFRS 17 address this topic?

Paragraphs 39, 108, and B93 – 95 provide guidance on this topic. Paragraph B5 may be relevant. Appendix D delineates concomitant amendments to IFRS 3 *Business Combinations*.

11.C. What other IAA documents are relevant to this topic?

Chapter 10 **Fair Value** is directly relevant. Contracts acquired in a business combination or in a portfolio transfer are measured by approaches consistent with the approaches used by the acquiring entity.

11.1. What are the general requirements of IFRS 3 for accounting for a business combination?

IFRS 3.4 requires the acquisition method of accounting to be applied to business combinations within its scope. The acquisition method views a business combination from the perspective of the acquirer. The acquirer purchases the assets and assumes the obligations of the seller. The measurement of the acquirer's assets and liabilities that existed before the acquisition is not affected by the transaction.

IFRS 3.5 describes the acquisition method as comprising four steps:

- Identifying the acquirer,
- Determining the acquisition date,
- Recognising and measuring the identifiable assets acquired and the liabilities assumed,
- Recognising and measuring goodwill or a gain from a bargain purchase.

Identifying the acquirer and determining the acquisition date are sometimes complex matters that do not require actuarial expertise. These issues are not in the scope of this IAN. Guidance can be found in IFRS 3.7, which in turn refers to IFRS 10 *Consolidated Financial Statements*, and in IFRS 3, B13-B18.

This chapter is primarily concerned with step 3 as it relates to insurance contracts and for acquisitions that do not form a business combination. There are some paragraphs and an appendix that provide some information about the other aspects of steps 3 and 4 to help the actuary understand the broader context in which the measurement of insurance contracts assets and liabilities is taking place.

11.2. What are the requirements of IFRS 17 for insurance contracts acquired in a business combination or in a transfer of contracts that do not form a business?

IFRS 17 provides guidance on the treatment of contracts acquired in a business combination or in a transfer of contracts that do not form a business combination. The distinction between a business combination and a transfer of contracts that does not form a business is discussed below. The application of the broader, non-insurance specific, guidance relating to business combinations and other acquisitions of assets or liabilities is discussed further in later sections of this chapter. The insurance-specific guidance in IFRS 17 relates to determining the initial contractual service margin (CSM) for acquired contracts. According to paragraphs B93-B95:

- the recognition date of the acquired contracts is the date of the business combination or of the transfer.
- the initial consideration received or paid for the contracts acquired is a proxy for the premiums received. The consideration excludes amounts paid for any other assets or liabilities acquired in the transaction. In a business combination, in many instances the initial consideration is the fair value of the contracts (see chapter 10 - Fair Value).
- the CSM for acquired contracts is calculated using the consideration as a proxy for the premium paid or received on the acquisition date. In a business combination, if the contracts are onerous, the difference between the consideration for the contracts and the fulfillment cash flows forms a loss component and is recognised as part of goodwill. If the transfer of contracts does not form a business combination, the entity records a loss in the current period for the difference and establishes a loss component for the contracts.

The implication of these paragraphs is that the general requirements of IFRS 17 apply to insurance or reinsurance contracts acquired in a business combination or a transfer and that the fair value of the contracts is used in the determination of goodwill in a business combination. The effect of this implication is that the entity examines contracts acquired in a business combination or a transfer to determine which are in the scope of IFRS 17, and then applies the guidance in IFRS 17 on measurement, presentation and disclosure to those contracts. There is not a presumption that a contract is insurance at the recognition date, even if it had been classified as insurance by the seller. For example, contracts that had been determined to be insurance contracts at the time that they originated, but, at the acquisition date, no longer transfer significant insurance risk, would not be in the

scope of IFRS 17 for the purposes of the acquirer. See also chapter 1– Classification of Contracts.

As noted, the consideration is used in determining the CSM for contracts that do not use the premium allocation approach (PAA). For contracts that use the PAA, the consideration represents the remaining unallocated premium of the relevant contracts.

Liabilities for claims incurred on contracts issued by the acquired entity do not have a CSM. IFRS 17 is generally construed to mean that the acquisition of claims liabilities constitutes the issuance of a contract that transfers the risk of adverse development to the acquirer. In some cases, the fair value and the fulfillment cash flows do not differ. In these cases, there is no CSM. In other cases, the fair value exceeds the fulfillment cash flows. This difference can be viewed as the part of the consideration that compensates the acquirer for the service provided. Hence any positive difference between the fair value and the fulfillment cash flows of claims liabilities acquired in a business combination or in another transfer is deferred and released into income over the coverage period, i.e., the period over which the acquirer is obligated to adjudicate the claims.

It is possible that the fair value of acquired insurance contracts is less than the fulfillment value. This situation might occur, for example, if the market conditions were such that the market participants required a margin for risk and profit that was less that the entity's adjustment for risk. A contributing factor may be that the fact that a fair value considers the credit-standing of the entity, whereas the fulfilment value does not. In this situation the acquired contracts are onerous. If the contracts are acquired as part of a business combination, there is a loss component but there is no effect on P&L because the amount by which the fulfillment value exceeds the fair value is considered in goodwill. If the acquisition of the contracts is not part of a business combination, the entity recognizes a loss for the difference and establishes a loss component, as it would for contracts it issues.

The guidance in IFRS 17 for acquired insurance and reinsurance contracts is consistent with the general guidance in IFRSs for business combinations. Most of the relevant guidance for business combinations is found in IFRS 3, *Business Combinations* (IFRS 3). Additional relevant guidance is in IFRS 13 *Fair Value Measurement (IFRS 13),* in IAS 12 *Income Taxes,* and in IAS 38 *Intangible Assets.* The guidance in these IFRSs that may affect accounting for business combination or transfers is discussed further below.

11.3. What is a business combination and how does it differ from a transfer of insurance contracts?

IFRS 17 does not define the terms "business combination". There is guidance for determining if a transaction is a business combination in IFRS 3, as discussed further below. For the purposes of this IAN, a transfer is a transaction involving contracts in the scope of IFRS 17 that may not constitute a business combination. Although not stated as such, the distinction likely makes no difference to the measurement of the assets or liabilities, but it may affect the goodwill and the tax accounting associated with the transaction.

11.4. What are the general requirements for determining if a transaction is a business combination?

IFRS 3 in effect defines a process that involves:

(a) Determining the nature of the transaction; i.e., determining whether it is a business combination or a different type of transaction,

a) Applying the acquisition method of accounting to transactions that are business combinations,

b) Recognising and measuring the identifiable assets acquired and liabilities assumed,

c) Recognising and measuring goodwill or a gain from a bargain purchase.

The following questions expand on these topics and on related matters.

IFRS 3 defines a business combination as "A transaction or other event in which an acquirer obtains control of one or more businesses." It goes on to state that transactions referred to as "true mergers" or "mergers of equals" are also business combinations. A "business" is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or their owners, members or participants. The "acquirer" is the entity that obtains control of the acquired. Appendix B of IFRS 3 provides further guidance on determining if the transaction constitutes the acquisition of a business and on identifying the acquirer.

For accounting purposes when there is a business combination, the "acquirer" is not always the entity which legally acquires the other entity. Under a "reverse acquisition", the entity whose stock is being legally acquired is the "acquirer" for accounting purposes, while the entity which is legally the acquirer becomes the "acquired" for accounting purposes. For example, this can occur where a larger entity arranges to have itself bought by a smaller entity, perhaps due to a preference to utilize the common stock characteristics of the smaller entity. The actuary may want to rely on their principal's accounting experts to determine who the acquirer and acquired entities are for accounting purposes.

11.5. What if the transaction is not a business combination?

IFRS 3 excludes from its scope the acquisition of an asset or a group of assets that does not constitute a business. *In such cases the acquirer shall identify and recognize the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in IAS 38 Intangible Assets) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase*. (IFRS 3.2(b)). This guidance presents the possibility that the initial value of acquired assets or liabilities is different from their fair values.

11.6. How can the guidance in IFRS 3 for determining if a transaction is a business combination be applied to a transaction that involves contracts in the scope of IFRS 17?

One can conclude from IFRS 3 that the necessary conditions for defining a transaction involving insurance contracts as business combinations are:

- the portfolio or group of contracts must constitute a business or be part of a business; and
- control over the portfolio must be obtained as a result of the transaction.

The addition of individual or multiple contracts to an entity's book of business in a single transaction may not be sufficient to qualify as a business combination. The act of issuing contracts is unlikely to be considered an acquisition or a business combination. For example, the issuance of several individual contracts to a single owner (e.g., as in the case of corporate-owned life insurance) or purchases of individual contracts in a secondary market (e.g., viatical settlements) would not be considered a business combination. A business combination may include the right to issue future contracts using the same distribution system associated with the purchased block. However, any values directly associated with such rights to issue contracts are not reflected in the liabilities or other values of acquired contracts but may be recognised as intangibles associated with the business combination, as discussed further below. Even without the transfer of the right to issue future contracts, the potential of the net cash flows associated with a portfolio of insurance contracts to generate profits may be sufficient for it to be deemed a business.

The transfer of a block of business from one entity to another may be considered a business combination if the acquirer obtains control of the associated contracts. An acquisition is distinct from a reinsurance transaction, other than novation or assumption reinsurance, since an acquisition transfers control over all aspects of contracts, whereas a reinsurer has at most limited control over the contracts reinsured. For example, an insurer may buy an individual line of business of a multi-line entity by buying certain assets, taking on its obligations through assumption reinsurance and taking control of the sellers' distribution system. The insurer in this example does not buy the shares of the seller, but nonetheless has acquired a business and would account for the transaction as a business combination.

11.7. What are the transition rules applying to business combinations or portfolio transfers that occur(ed) before the effective date of IFRS 17?

The general guidance in IFRS 17 for transition applies to contracts in the scope of IFRS 17 acquired in a business combinations or other transfer. As discussed above, the recognition date of the acquired contracts is the date of the business combination or of the transfer. Hence the transition does not require the entity to go back to the origination of the contracts, but rather to the date the entity acquired them. There is no need to restate any existing goodwill balances.

There may be business combinations that occurred before the effective date of IFRS 3 or that were acquired before the first-time adoption of IFRS. The IFRSs allow some

exceptions to the application to IFRS 3 to these transactions. For example, if a company deemed a business combination to be a merger under guidance in effect before IFRS 3, the initial value of the contracts acquired may not have been their fair value. The recognition date for these contracts is the acquisition date, nonetheless, not the original inception date. IFRS 17 nonetheless seems to require that the initial value for transition be the fair value at the acquisition date (see paragraph C4a) if the full retrospective or modified retrospective approach is used, or at the transition date if the fair-value approach is used. There may be less evidence about the fair value of contracts at the acquisition date for these transactions (those for which acquired contracts had not been measured at fair value on the acquisition date) than for contracts that the entity measured at fair value on the acquisition date. The actuary may find that the fair-value approach is more appropriate for these contracts.

Appendix to Chapter 11

This Appendix provides further information about IFRS 3.

What is the guidance in IFRS 3 for recognizing and measuring identifiable assets acquired and liabilities assumed in a business combination?

IFRS 3 requires the identifiable assets acquired and liabilities assumed in a business combination to be measured at fair value at the acquisition date (IFRS 3.10 and 3.18). There is an emphasis on recognizing all identifiable assets acquired and liabilities assumed, reflecting the Board's desire for entities to fully consider the difference between identifiable intangible assets and goodwill. The treatment of goodwill (see further below) is different from the treatment of intangible assets with definite lives and the allocation of the purchase price among these items affects the emergence of future profits.

To qualify for recognition, identifiable assets and liabilities acquired

- must meet the definition of assets or liabilities (IFRS3.11); and
- must be part of what the acquirer and the acquiree exchanged in the business combination rather than the result of a separate transaction (IFRS 3.12). Examples of separate transactions that do not constitute part of the business combination include settlement of pre-existing relationship between the acquirer and acquiree and remuneration to employees or former owners of the acquiree for future services.

Applying the recognition principles may result in recognition of assets or liabilities that the seller had not recognised in its financial statements. The application of the recognition and measurement concepts in IFRS 3 for intangible assets and other acquired liabilities is discussed below. The recognition and measurement of tangible invested assets, such as assets arising from ceded reinsurance invested assets, is not in the scope of this IAN. It is worth noting that there are some exceptions to the use of fair value measurement; for example, liabilities from retirement benefit plans are measured according to IFRS guidance for pension liabilities.

What are some examples of intangible assets arising from a business combination involving contracts in the scope of IFRS 17 and what are the accounting requirements?

Several potential intangible assets could arise from a business combination involving contracts issued by insurers. These include, but are not limited to:

- renewal periods for short-duration contracts
- distribution systems or relationships
- customer relationships
- service agreements
- brand names, trademarks, and copyrights
- proprietary software or technology

- licenses to transact insurance business
- product approvals and registrations
- value of liability guarantee

The following paragraphs provide descriptions of some of the more common intangible assets identified in combinations of insurance entities and some related considerations. The first step is, as already noted, to determine if the intangible asset can be recognized. If so, the entity determines the asset's fair value and the appropriate technique for the amortization of the asset. Full development of common valuation and amortisation methods is beyond the scope of this IAN. While specific possible amortisation approaches are described for these assets, it should be kept in mind that IAS 38 provides that the amortisation period used should reflect the pattern in which an asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method could be used. There is also the possibility that some intangible assets have indefinite lives, and hence the intangible asset would not be amortised, but rather tested for recoverability, referred to as testing for impairment. The actuary may wish to consult with accountants and other professionals, such as valuation experts, for assistance in determining which other potential intangible assets should be recognised, and how they should be measured and amortised and tested for impairment.

Value of renewal periods for short-duration contracts (sometimes also referred to as "customer lists" for short-duration contracts)

A common situation in non-life insurance is the establishment of an intangible asset related to the value of potential renewals of short-duration contracts. The fair value may be based on market pricing benchmarks if such transactions and related benchmarks are reasonably well established for the market in which the acquired business resides. Such benchmarks in at least some markets are based on a percentage of the premiums in-force or a percentage of annual premium writings. Absent such benchmarks, the fair value may be based on the expected future distributable earnings from renewal contracts, usually net of the cost of capital, discounted at a market discount rate commensurate with the risk of the cash flows. Among the methods for amortisation that have been used are:

1. in relation to expected distributable earnings used to derive the fair value estimate; and
2. based on expected premiums from future renewals.

Value of distribution systems/relationships

The value associated with a distribution system may be significant, especially for distribution arrangements involving contingent commissions, business processing or purchases of third-party intermediaries. Fair values of such systems can be derived from cash flow models and from valuation specialists. Two of the possible amortisation methods that have been used for future business are 1) in relation to expected distributable earnings, and 2) proportional to new business premiums.

Customer relationships and customer list – long duration contracts

Selling unrelated contracts to existing customers may provide the basis for an intangible asset or it may be included in goodwill, depending on the facts and circumstances. Care should be taken not to double count the value the asset related to a customer relationship and the value of a distribution system, if the considerations relate to the same future contracts and cash flows.

Service agreements

When a seller has entered into third-party contracts for certain services like claims administration, the acquirer considers whether an intangible asset might exist. There may be an intangible asset for the service component of investment or insurance contracts when this component is separated for recognition and measurement. Due consideration is given to whether the terms of such agreements are at, below or above current market rates. The intangible asset, if any, may relate to the amount in fees that represent an above-market margin.

Amortisation methods used for such intangibles include:

1. in relation to the net revenue (fees charged less costs to provide the service) earned for providing the service; and
2. on a straight-line basis over the contract period.

Brand names, trademarks, copyrights

The entity being acquired may have a legal right to certain items such as identifying names, slogans and logos that would qualify for separate recognition as intangible assets. Identifying the additional cash flows associated with such items may prove difficult. Amortisation would likely be based on the projected cash flows used to estimate the fair value. However, some legal rights may be renewable indefinitely leading to the conclusion that the intangible should not be amortised.

Proprietary software or technology

Some insurers have developed expert systems that can be separately recognised as having value. Such systems can include underwriting, distribution/cross selling, and investment management. Amortisation of such systems-related intangible assets may be a straight line over an assumed lifetime of the system.

Licenses to transact insurance business

IAS 38.88 requires entities to assess whether intangible assets have either a finite useful life or indefinite useful life. Licenses might be viewed as having an indefinite useful life, such that their value is not amortised over time (although they may be subject to an impairment test). Their value might be derivable from market transactions for shell entities or from brokers in that market.

Product approvals or registrations

Product forms that have been approved for issue in certain jurisdictions can be determined to be intangible assets. The value could be viewed as the alternative cost to develop the same product and go through the approval process. Alternatively, the value could be viewed as something more if the product is in a niche market with limited access. Amortisation of the value could be based on the anticipated revenues expected from the sales of the new product.

Value of Liability Guarantees

Business combinations sometimes include guarantees regarding the claims liability run out, such as a guarantee to reimburse the acquirer for losses above a certain amount. The actuary will need to consider when such a guarantee is an identifiable asset that should be recognized at its fair value. When the guarantee is treated as a reinsurance asset and measured according to the entity's current accounting policies the difference between the recorded asset and the fair value of the guarantee is reported as an intangible asset or liability. This treatment is consistent with the accounting for indemnification assets, as given in IFRS 3.28 and 3.57.

How does the entity account for goodwill or for a gain from a bargain purchase?

IFRS 3 requires recognition of goodwill as of the acquisition date. Goodwill is the excess of the consideration transferred over the net of the identifiable assets and liabilities acquired. Identifiable assets here include those intangible assets which have been recognized in connection with the acquisition. Goodwill implicitly includes intangible assets that do not satisfy the criteria for recognition. (IFRS 3.32)

Because consideration may include not only cash, but equities, future consideration or other types of compensation, the determination of the value of consideration can become complex. IFRS 3 provides some guidance on determining the value of consideration transferred. Of particular note is the fact that transaction costs, such as legal, advisory or accounting fees associated with the transaction are not part of the consideration.

Goodwill represents a payment made by the acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified, recognised or reliably measured individually. The value of goodwill need not be justified, but is subject to tests of impairment. Goodwill is not amortised. Goodwill is to be measured subsequently at the amount recognised at the acquisition date less any accumulated impairment losses. The goodwill carrying amount must be tested for impairment in accordance with the requirements of IAS 36, *Impairment of Assets* (IFRS 3.B63).

The excess of the consideration transferred over the net of the identifiable assets and liabilities acquired may be negative. In this case, the acquirer reassesses the fair value of acquired assets and liabilities to be sure that all acquired assets and assumed liabilities have been identified, recognised and measured properly. If, after making adjustments for the reassessment, the excess remains negative, a bargain purchase is said to have occurred.

There is no goodwill. The gain on the business combination is recognised in the acquirer's profit and loss in the period in which the acquisition takes place (IFRS 3.33 – 3.36).

Can there be a deferred tax asset or liability as a result of a business combination or other transfer?

The guidance for deferred taxes is found in IAS 12 *Income Taxes.* The fair value of acquired assets and liabilities assumed in a business transaction may be different from the tax value of the respective assets or liabilities. Temporary differences arise from the business combination when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, the initial value of insurance contracts acquired in a business combination is fair value, but the tax basis of the contracts may remain at the basis that it had to the seller. This difference is generally a taxable temporary difference which gives rise to a deferred tax asset or liability. (IAS 12.19) The deferred tax asset or liability is the amount of the difference multiplied by the tax rate that is expected to apply when the difference reverses. Hence the calculation may require a projection of the reversal of the difference if it is necessary to reflect varying tax rates. There is however no discounting in the calculation of a deferred tax asset or liability.

The resulting deferred tax asset or liability affects goodwill (IAS 12.66). When a deferred tax asset or liability is recognized as a result of a difference between the fair value of an item and its tax value in a business combination, this difference is considered in the determination of the goodwill or the amount of the bargain purchase gain.

Note that the recognition of a deferred tax asset depends on the entity being able to assert that the asset is recoverable. A deferred tax asset is generally recognised for deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized. The carrying amount of a deferred tax asset is reviewed at the end of each reporting period. The entity reduces the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilized. Any such reduction can be reversed to the extent that it subsequently becomes probable that sufficient taxable profit will be available for the asset to be utilized.

What are the disclosure requirements related to business combinations?

Disclosure guidance for business combinations is found in IFRS 3, B64-B67. The disclosures include both qualitative and quantitative notes that "enable users of [the entity's] financial statements to evaluate the nature and financial effects of the business combination". The disclosures do not supplant disclosures required by IFRS 17. It may be necessary to make some of the disclosures for the acquired business separately. Although not explicitly stated in IFRS 17 or in IFRS 3, these disclosures may apply to transfers as well.

Chapter 12 – Transition

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

12.A. What does this chapter address?

This chapter considers the one-time event of presenting statements applying IFRS 17 for the first time. It has four sections: an overview and then a section for each of the three transition approaches described in IFRS 17 – the retrospective approach of IAS 8 and the alternative approaches introduced by IFRS 17, modified retrospective and fair value. The chapter has a sample timeline. It also references content from chapter 10 on fair value measurement.

12.B. Which sections of IFRS 17 address this topic?

Appendix C of IFRS 17 provides guidance on this topic.

12.C. What other IAA documents are relevant to this topic?

None

Overview

12.1. Where does the IASB describe the requirements for transition of the in-force insurance contracts from current accounting standards to IFRS 17?

The effective date, requirements and approaches are described in Appendix C of IFRS 17 and the accompanying Basis for Conclusions.

The transition requirements apply when an entity first applies IFRS 17.

12.2. What is the effective date of IFRS 17?

IFRS 17 applies to annual reporting periods beginning on or after 1 January 2021, with early application permitted. The start of the annual reporting period in which an entity first applies IFRS 17 is called the date of initial application. Some jurisdictions may adopt other effective dates.

12.3. What IFRS 17 comparative information is required?

There is a requirement to provide IFRS 17 financial statements (comparatives) as of the beginning of the period immediately preceding the date of initial application.

The dates that follow apply for entities with quarterly financial reporting and an assumed date of initial application of 1 January 2022. Analogous dates would apply in other situations.

On 31 March 2022 the entity will report the following on the new IFRS 17 basis:

- the 31 December 2020 statement of financial position
- the statement(s) of financial performance for the 3-month period ending 31 March 2021

- the 31 March 2021 statement of financial position will not be presented, but will be necessary to the extent needed to prepare the 31 March 2021 statement(s) of financial performance
- the 31 December 2021 statement of financial position
- the statement(s) of financial performance for the 3-month period ending 31 March 2021
- the 31 March 2021 statement of financial position

Further, on 31 March 2021, the entity will disclose the impact of the change in accounting standards. This disclosure will be as of 31 December 2020.

12.4. Can more than one year of IFRS 17 comparative information be presented?

Yes, an entity is permitted to present more than one year of IFRS 17 comparative information (paragraphs C25-C28). The beginning of the earliest adjusted comparative period presented (which would be the beginning of the period immediately preceding the date of initial application when only one year of comparative information is presented) is called the "transition date". In the example shown in question 6.3, the transition date would be December 31, 2020 (January 1, 2021). If an entity chooses to present two years of comparative information (both of which are based on IFRS 17), the transition date would be December 31, 2019 (January 1, 2020). See paragraphs C2 and C25.

12.5. If provided, how is comparative information for earlier periods presented?

If the comparative information and disclosures for earlier periods are adjusted by applying IFRS 17, question 12.3 above applies. If the comparative information and disclosures for earlier periods are unadjusted, paragraph C27 requires the entity to "clearly identify the information that has not been adjusted, disclose that it has been prepared on a different basis, and explain that basis."

12.6. If the implementation of IFRS 9 is deferred until 1 January 2021, what is the interaction with the IFRS 17 comparative financial statements?

IFRS 9 does not require comparative financial statements. However, the implementation of IFRS 9 (e.g., the designation of assets) might be different under IFRS 17 than under the current financial reporting standards. If so, the IFRS 17 comparative financial statements would be presented assuming the implementation of IFRS 9 that is consistent with IFRS 17. Assuming the above timeline with one year of comparatives, the re-designation of assets under IFRS 9 would be as of 31 December 2020 for the purposes of IFRS17 comparatives only.

12.7. If IFRS 9 is implemented before IFRS 17, are financial assets re-designated when IFRS 17 is implemented?

The guidance for re-designation and related disclosures is in paragraphs C29-C33. If there are assets designated as fair value through profit or loss to avoid an accounting mismatch, that designation must be revoked if the accounting mismatch no longer exists under IFRS 17. Otherwise, re-designation of assets is permitted but not required.

As described in question 12.6 above, the IFRS 17 comparative financial statements would be presented assuming the implementation of IFRS 9 that will be adopted with IFRS 17.

12.8. What time period does the transition guidance cover?

The transition guidance applies to all insurance contracts in force at the transition date, which is 31 December 2020 in the above timeline. All insurance contracts issued after that date would be subject to IFRS 17.

12.9. In addition to IFRS 17, what other guidance applies to transition?

Implementing IFRS 17 is considered a change in accounting policy, so IAS 8 *Accounting Policies, Changes in Accounting Estimates and Changes in Accounting Policies* applies, except, per paragraph C3, the entity need not disclose the quantitative information required by paragraph 28(f) of IAS 8.

12.10. What is the impact on previous business combination balances of paragraph C4(b) of IFRS17?

Paragraph C4(b) requires the entity to derecognise all balances related to business combinations that would not have existed had IFRS 17 been in effect at the time of the business combination. For example, value of business acquired (VOBA) balances will be derecognised, but goodwill balances will be unchanged at the transition date.

12.11. What is to be measured or determined at transition?

At the transition date, the following is required for each group of contracts:

- the carrying value of the liability (or asset), with separate measurement of the risk adjustment and the CSM or loss component,
- the "locked-in discount rate", being the discount rate used for CSM accretion,
- the accumulated OCI (if the OCI option is elected), and
- the balance of unamortised insurance acquisition cash flows (unless the fair value approach is used).

12.12. How should these items be measured or determined?

Appendix C describes three approaches for transition: full retrospective, modified retrospective and fair value.

The measurement of fulfilment cash flows at the transition date is a straightforward application of paragraphs 33-37. However, the CSM or loss component, the locked-in discount rate and the accumulated OCI all require information from the date of initial recognition, which may be many years before the date of transition. These items are therefore the focus of the transition guidance.

The following questions of this Chapter describe the identification of groups of contracts, the determination of the locked-in discount rate, the measurement of accumulated OCI, and the measurement of the CSM or loss component under the three approaches (full retrospective, modified retrospective, fair value).

12.13. How does the entity decide which approach to use for each group of contracts?

As set out in paragraph C5, the full retrospective approach must be used unless it is impracticable to do so, in which case the entity must choose between the modified retrospective approach and the fair value approach. However, if reasonable and supportable information necessary to apply the modified retrospective approach is not available, the fair value approach must be used.

12.14. How does the entity identify groups of contracts at transition?

Paragraphs 14-24 describe the criteria for identifying groups of contracts. Under the full retrospective approach, identification of groups requires the assessment of these criteria as at the date of initial recognition of the contracts in each group. If this information is not available, the full retrospective approach would not be used. Identification of groups under the modified retrospective approach and the fair value approach are described in later questions of this chapter.

12.15. What other information is needed to use the full retrospective approach?

See questions 12.24 to 12.32. If any material information is not available, the full retrospective approach would not be used.

12.16. Would multiple approaches be used on a single group of contracts?

For a group of contracts, only one approach would be applied.

12.17. What does impracticable mean?

IAS 8 states:

*"Applying a requirement is impracticable when the entity cannot apply it after **making every reasonable effort** to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:*

(a) the effects of the retrospective application or retrospective restatement are not determinable;

*(b) the retrospective application or retrospective restatement **requires assumptions about what management's intent would have been in that period**; or*

*(c) the retrospective application or retrospective restatement **requires significant estimates of amounts and it is impossible to distinguish objectively information** about those estimates that:*

I. provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and

II. would have been available when the financial statements for that prior period were authorised for issue from other information."

Effectively, this means that the entity must demonstrate that although it has made every reasonable effort to gather the necessary information to enable it to determine the

required elements retrospectively, that information is not available, or not available in a form that would enable it to be used without undue cost and effort. Information might be unavailable for a variety of reasons including:

- the information is no longer in the entity's possession;
- the information is available but outside the entity's normal retention policy and so might not be complete;
- the entity has the information but is unusable because of technological constraints;
- the need to determine what decisions management might have taken in the past (e.g., declaration of bonus rates);
- the information requires hindsight to understand management's intent or the entity's view.

Paragraph BC378 gives examples of items needed for retrospective application for which measurement would often be impracticable.

12.18. Are separate disclosures required for groups using different approaches?

Yes. Paragraphs 114-116 describe the required disclosures.

12.19. After transition, can new contracts be added to the groups established at transition?

The disclosure requirements of paragraphs 114-116 would prohibit new contracts being added to groups measured at transition using the modified retrospective approach or the fair value approach.

12.20. What is different for groups of insurance contracts with (vs. without) direct participation features?

The locked-in discount rate is not needed for CSM accretion or future CSM adjustments and so is only required if the OCI option is elected.

12.21. What is different for groups of contracts measured using the premium allocation approach?

For the liability for remaining coverage, there is no risk adjustment or CSM or loss component to be determined at transition. Also, the locked-in discount rate is not needed.

12.22. What is different for incurred claims liabilities?

There is no CSM or loss component to be determined at transition. The locked-in discount rate is not needed for CSM accretion or future CSM adjustments and so is only required if the OCI option is elected.

12.23. What is different for groups of reinsurance contracts?

There is never a loss component for groups of reinsurance contracts. This is true even if (per paragraph 66(c)(ii)) losses are recognised in profit and loss (rather than adjusting the CSM) to mirror the treatment applying to a group of underlying direct contracts.

The Full Retrospective Approach

12.24. Are simplifications and approximations permitted when applying the full retrospective approach?

The full retrospective approach involves looking back to the date of initial recognition and determining the liability (and in particular, the CSM or loss component) on that date as if IFRS 17 had been in effect. Then, to determine the CSM or loss component at the transition date, the CSM or loss component at the date of initial recognition would be adjusted through time as described in paragraphs 43-45 (CSM) and 50-52 (loss component).

Simplifications and approximations are permitted if they do not have a material impact on the results. If any material information is not available, the full retrospective approach would not be used.

12.25. How are groups of contracts identified?

Paragraphs 14-24 describe the criteria for identifying groups of contracts. Under the full retrospective approach, identification of groups requires the assessment of these criteria as at the date of initial recognition of the contracts in each group.

12.26. How is the locked-in discount rate determined?

The locked-in discount rate is the discount rate that would have been established at the date of initial recognition as described in paragraph 36.

12.27. How is the liability (and in particular, the CSM or loss component) determined at the date of initial recognition?

Actual policy data for the contracts in the group would be used. Information (e.g., assumptions, pre-coverage acquisition expenses) required to estimate future cash flows, the risk adjustment and the CSM or loss component would, to the extent possible, be consistent with the information that would have been available at the date of initial recognition, without the use of hindsight.

In particular, the risk adjustment at the date of initial recognition should reflect the assessment of risk from the perspective of the entity as at the date of initial recognition. As noted in question 12.26 above, the discount rate would be the discount rate that would have been established at the date of initial recognition as described in paragraph 36.

12.28. How is the CSM or loss component measured at the transition date?

The CSM or loss component at the transition date would be measured by taking the CSM or loss component at the date of initial recognition (determined as in question 12.27 above) and adjusting through time as described in paragraphs 43-45 (CSM) and 50-52 (loss component) of IFRS 17.

12.29. Should contracts that are not in-force at the transition date, but which at the date of initial recognition would have been included in the group of contracts as determined in question 12.25 above, be included in the retrospective calculation?

Yes. All contracts that were in the group at the date of initial recognition would contribute to the determination of the liability at the date of initial recognition. Furthermore, cash flows and coverage units associated with these contracts would contribute to the adjusting through time of the CSM or loss component described in question 12.28 above.

12.30. What pattern should be used for CSM amortisation between the date of initial recognition and the transition date?

The adjustments made to the CSM or loss component would, to the extent possible, be consistent with the information that would have been available at the date each adjustment would have been made, without the use of hindsight. However, per paragraph C3(b), for groups of contracts with direct participation features, the option described in paragraph B115 (to reflect the economic offset of derivatives in profit and loss rather than the CSM) would not be applied.

The adjustments to the CSM or loss component would be made as at each reporting date between the date of initial application and the transition date. If the resulting CSM or loss component would be materially similar, adjustments could be made less frequently, (e.g., annually).

12.31. If the OCI option is elected, how is the accumulated OCI at the transition date measured?

For groups of contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder, the accumulated OCI at transition is the difference between the fulfilment cash flows measured using the locked-in discount rate and the fulfilment cash flows measured using the discount rate in effect at the transition date.

For groups of contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholder but which are not insurance contracts with direct participating features where the entity holds the underlying items (i.e., when paragraph 88 applies), the systematic allocation that would have been adopted at the date of initial recognition (per paragraph B132) would be determined and applied retrospectively to measure the accumulated OCI at transition.

For groups of contracts applying the premium allocation approach, the accumulated OCI at transition for the liability for incurred claims is the difference between the fulfilment cash flows measured using the discount rate in effect at the date the claim was incurred and the fulfilment cash flows measured using the discount rate in effect at the transition date.

For groups of contracts with direct participation features where the entity holds the underlying items (i.e., when paragraph 89 applies), the accumulated OCI at transition would be measured retrospectively applying paragraphs B134-B136.

12.32. How is the balance of unamortised insurance acquisition cash flows determined?

The balance of unamortised insurance acquisition cash flows would be determined by taking the insurance acquisition cash flows allocated to the group for the purpose of calculating the CSM or loss component at the date of initial recognition and removing the portion that would have been amortised under paragraph B125.

The Modified Retrospective Approach

12.33. When can the modified retrospective approach be used?

When it is impracticable to apply the full retrospective approach to a group of contracts, the entity must choose to use either the modified retrospective approach or the fair value approach. However, the entity may only choose the modified retrospective approach if it can obtain reasonable and supportable information necessary to do so. If not, as per the requirements of IFRS17, the fair value approach must be used.

12.34. What is the modified retrospective approach trying to achieve?

The objective of the modified retrospective approach is to achieve the closest outcome to the full retrospective approach possible.

12.35. How does the entity achieve this objective?

The entity would maximise the use of information that would have been used to apply the full retrospective approach, though only to the extent that information is reasonable and supportable and available without undue cost or effort.

Appendix C describes specific modifications, each of which is permitted only to the extent that the entity does not have reasonable and supportable information to apply the full retrospective approach (per paragraph C8). The assessment of which modifications are permitted would be made for each modification for each group of contracts.

For the remainder of this section, "available information" should be read as "reasonable and supportable information that is available without undue cost or effort".

12.36. How are groups of contracts identified under the modified retrospective approach?

If the information is available, groups of contracts would be identified applying paragraphs 14-24.

Paragraph 14 requires the identification of portfolios of insurance contracts, where a portfolio comprises contracts that are subject to similar risks and managed together. To the extent information is not available, one of the permitted modifications of the modified retrospective approach allows the entity to identify portfolios of contracts based on how its business is managed at transition.

Furthermore, insurance contracts with direct participation features would be in different portfolios than contracts without direct participation features. At the time of transition, information from the date of initial recognition about whether contracts would have met the definition of insurance contracts with direct participation features when they were issued may not be available. In this case, one of the permitted modifications of the

modified retrospective approach allows the entity to use information available at transition to determine whether a contract meets the definition of an insurance contract with direct participation features, i.e., contracts would be included in a portfolio of insurance contracts with direct participation features if they meet the definition of insurance contracts with direct participation features at the date of transition.

Paragraphs 15-21 indicate that portfolios are split into three (or more if desired) groups based on the profitability of contracts at initial recognition. At the time of transition, information from the date of initial recognition about the profitability of contracts issued in past years may not be available. In this case, one of the permitted modifications of the modified retrospective approach allows the entity to use information available at transition to assess the profitability of contracts for the purpose of grouping. That is, information about the profitability of contracts currently being issued can be applied to similar contracts issued in past years. However, such information must be reasonable and supportable, otherwise the fair value approach would be used. The longer it has been since the policy has been issued may be a consideration in determining if the information at transition is reasonable and supportable.

Paragraph 22 requires the groups determined per paragraphs 14-21 to be further divided so that contracts issued more than one year apart are not included in the same group. Paragraph C10 permits a modification of this requirement when information is not available. This modification allows the entity to group contracts issued more than one year apart to allow the application of the modified retrospective approach whenever reasonable and supportable information necessary to do so is available. For example, if reasonable and supportable information is only available for contracts issued within five years of the transition date and the entity wishes to use the modified retrospective approach for such contracts, the entity could establish two groups of contracts, viz., those issued within five years of the transition date (for which the modified retrospective approach would be applied) and those issued more than five years before the transition date (for which the fair value approach would be applied).

12.37. How is the locked-in discount rate determined under the modified retrospective approach?

If contracts issued more than one year apart are included in the same group (i.e., the modification in paragraph C10 is made), the entity is permitted to determine the locked-in discount rate using the discount rate in effect at the date of transition rather than the discount rate in effect at the date of initial recognition.

Otherwise, if available, the locked-in discount rate is the discount rate that would have been established at the date of initial recognition as described in paragraph 36.

If not available, one of the permitted modifications of the modified retrospective approach allows the entity to use the relationship between an observable yield curve and the current discount rate to estimate the discount rate as at the date of initial recognition as follows:

If there is an observable yield curve that approximates the current discount rate for at least three years before the transition date, that observable yield curve at the date of initial recognition would be used to determine the locked-in discount rate.

If such an observable yield curve does not exist, but there is an observable yield curve with a reasonably consistent spread to the current discount rate, the average spread between that observable yield curve and the current discount rate would be applied to that observable yield curve at the date of initial recognition to determine the locked-in discount rate. The average spread should be an average over at least three years before the transition date (paragraph C13b).

12.38. How is the CSM or loss component at the transition date measured under the modified retrospective approach?

The full retrospective approach would be used to the extent information is available. The following modifications are permitted to the extent information is not available:

Insurance contracts without direct participation features

- **Discretionary cash flows** – The entity would use information at the transition date (rather than the date of initial recognition) to determine how to identify discretionary cash flows for the purpose of applying paragraphs B94-B96. That is, the entity would use policies on discretionary payments that apply at the date of transition if the policies on discretionary payments that applied at the time of initial recognition are not available.
- **Future cash flows** – The future cash flows at the date of initial recognition would be estimated as the future cash flows at the transition date (or an earlier date if the information is available) adjusted by the cash flows that are known to have occurred between the initial recognition and the transition date (or earlier date). Such known cash flows would include cash flows related to all contracts that would have been in the group at the date of initial recognition, including contracts that are no longer in force at the transition date.
- **Risk adjustment** – The risk adjustment at the date of initial recognition would be estimated as the risk adjustment at the transition date adjusted by the expected release of risk before that date. The expected release of risk would be based on the release of risk for similar contracts the entity is issuing at the transition date (paragraph C14).
- **CSM amortisation** – The entity would estimate the amount of CSM recognised in profit or loss because of the transfer of services (paragraph 44(e) between the date of initial recognition and the transition date by comparing the remaining coverage units (for contracts still in-force at the transition date) with the coverage units provided under the group of contracts before the transition date.
- **Loss component** – If there is a loss component at initial recognition, the entity would estimate the amount allocated to the loss component before the transition date using a systematic allocation consistent with the modifications adopted above.

Insurance contracts with direct participation features

The entity would measure the CSM at the transition date as the total fair value of the underlying items at the transition date minus:

- the fulfilment cash flows at the transition date, adjusted as described in paragraph C17(c), and
- (if CSM), minus the amount of CSM that relates to service provided before the transition date, estimated by comparing the remaining coverage units with the coverage units provided under the group of contracts before the transition,
- (if loss component), adjust the loss component to nil and increase the liability for remaining covering by the same amount.

If information is not available to apply a permitted modification, the fair value approach must be used.

12.39. If the OCI option is elected, how is the accumulated OCI at the transition date measured under the modified retrospective approach?

For contracts with direct participation features where the entity holds the underlying items (i.e., when paragraph B134 applies), the accumulated OCI at transition would be the accumulated OCI on the underlying items.

Otherwise, the accumulated OCI at transition would be:

- the difference between the fulfilment cash flows measured using the locked-in discount rate and the fulfilment cash flows measured using the discount rate in effect at the date of transition, for contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder, and
- nil for contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholder.

Furthermore, if contracts issued more than one year apart are included in the same group (i.e., the modification in paragraph C10 is made), the entity is permitted to determine the accumulated OCI as nil.

Note that the accumulated OCI would be nil whenever (per the first paragraph of question 12.36 above) the entity chooses to determine the locked-in discount rate as the discount rate in effect at the date of transition.

12.40. How is the balance of unamortised insurance acquisition cash flows determined under the modified retrospective approach?

The modification related to future cash flows in question 12.37 above can be used if the information required to determine the balance of unamortised insurance acquisition cash flows retrospectively (see question 12.31) is not available.

The Fair Value Approach

12.41. What is the fair value used for?

The CSM or loss component at transition is determined as the fair value of a group of contracts at the transition date minus the fulfilment cash flows of the group as at the transition date.

12.42. How are groups of contracts identified under the fair value approach?

Per paragraphs C21-C22, the entity may choose to use the information available at transition rather than the information as at initial recognition to identify groups of contracts. This includes identifying portfolios of insurance contracts (see question 12.35 above).

Furthermore, per paragraph C23, the entity may choose not to apply paragraph 22 and thereby include contracts issued more than one year apart in a group.

Therefore, when applying the fair value approach at transition, the entity may identify portfolios of contracts based on how it manages the business at transition and determine there are three groups per portfolio (onerous, no significant risk of becoming onerous, other), with no division of those groups by year of issue.

12.43. How is the locked-in discount rate determined under the fair value approach?

Per paragraph C23, the entity may choose to determine the locked-in discount rate as the discount rate in effect at the date of transition.

Note that the same locked-in discount rate would apply to groups within the same portfolio.

12.44. How is the fair value of a group of contracts as at the transition date measured?

The fair value of a group of contracts is analogous to the consideration received/paid on portfolio transfer or business combination. It is the amount the entity would have to pay a third party to take on the obligations and risks of the group.

IFRS 13 Fair Value Measurement provides guidance on measuring fair value. See chapter 10 for guidance on the application of IFRS 13 to insurance contracts on transition to IFRS 17.

The fair value at the date of transition would use observable market information, assumptions, economic information, views on the cost of risk etc. as at the date of transition.

12.45. How are the fulfilment cash flows of the group as at the transition date measured?

The measurement of fulfilment cash flows at the transition date is described in paragraphs 33-37.

12.46. If the OCI option is elected, how is the accumulated OCI at the transition date measured under the fair value approach?

For contracts with direct participation features where the entity holds the underlying items (i.e., when paragraph B134 applies), the accumulated OCI at transition would be the accumulated OCI on the underlying items.

Otherwise, the entity can choose to set the accumulated OCI to nil, or to measure the accumulated OCI retrospectively if the information is available.

12.47. Is balance of unamortised insurance acquisition cash flows required under the fair value approach?

No.

Section D – Other IFRS 17 Topics

This section includes three chapters that cover topics that do not logically fall within any of the other sections. These are:

- Embedded Derivatives – Chapter 13
- Contract Modifications and Derecognition - Chapter 14
- Measurement, Presentation and Disclosure – Chapter 15

Chapter 13 discusses the issues which may arise in detecting and identifying embedded derivatives in such contracts which may need to be separated. This chapter only considers the requirements under IFRS 17 for the separation of certain derivatives embedded in contracts subject to the scope of IFRS 17. Further information about embedded derivatives based on other IFRS is found in IAN 10 Embedded Derivatives.

Chapter 14 discusses what is and is not considered to be a contract modification and how to account for them. The chapter also discusses the circumstances under which a contract is derecognised whether due to a contract modification or otherwise.

Chapter 15 discusses the measurement, presentation and disclosures resulting from IFRS 17. In many instances these are significantly different from those of most existing accounting regimes used for insurance contracts and companies. This chapter also considers changes in presentation permitted or required when using the PAA. Any changes permitted when using the VFA are discussed in chapter 8.

Chapter 13 – Embedded Derivatives

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

13.A. What does this chapter address?

This chapter considers the requirements under IFRS 17 for the separation of certain derivatives embedded in contracts subject to the scope of IFRS 17. This chapter discusses the issues which may arise in detecting and identifying embedded derivatives in such contracts which may need to be separated. Further information about embedded derivatives based on other IFRS is found in the existing IAN 10 Embedded Derivatives.

13.B. Which sections of IFRS 17 address this topic?

Paragraphs 11c and B10 provide guidance on this topic.

13.C. What other IAA documents are relevant to this topic?

None

13.1. What is a derivative and an embedded derivative?

Derivatives and embedded derivatives are defined in IFRS 9 in paragraph 4.3.1. As in IAS 39, IFRS 9 differentiates between derivatives and embedded derivatives and accordingly references to *"derivatives embedded in the contract"* (as in paragraphs 54 (a) and 70 (a) of IFRS17 relating to the premium allocation approach) might be seen to refer to the definition of a derivative rather than to that of an embedded derivative.

Paragraph 4.3.3 of IFRS 9 includes conditions for separating an embedded derivative, which are applicable according to paragraph 11 (a) of IFRS 17 to insurance contracts and other contracts in the scope of IFRS 17. The guidance regarding definition of derivatives and embedded derivatives and the conditions for separation of those has not changed from those in IAS 39 and accordingly the contents of IAN 10 Embedded Derivatives referring to IAS 39 remains valid. This also applies to other aspects of accounting for embedded derivatives that are to be separated.

13.2. What are the IFRS 17 requirements on the accounting for derivatives embedded in the contract and embedded derivatives?

The requirements in IFRS 17 on the accounting for derivatives embedded in the contract and embedded derivatives are limited (see paragraph 11(a) as noted above).

IFRS 9 defines a derivative as a *"financial instrument or other contract within the scope of" and* IFRS 9 as *"with all three of the following characteristics:*

a. Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. *It is settled at a future date."*

On the conditions for separating an embedded derivative in paragraph 4.3.3 of IFRS 9:

- Paragraph 4.3.3 (b) (meeting stand-alone the definition of a derivative) might be seen as not met if the embedded derivative would be considered stand alone under IFRS 17 (see paragraphs B10 of IFRS 17 and 2.1 (e) of IFRS 9).
- Paragraph 4.3.3 (c) (fair value measurement of the entire contract) for separation might be seen to be met generally by contracts in the scope of IFRS 17 since the condition might be seen to refer explicitly to the measurement of the entire contract.

Paragraph B.4.3.1 of IFRS 9 notes that paragraph 4.3.3 of IFRS 9 *"requires the entity to identify any embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently at fair value through profit or loss."*

Embedded derivatives that are not required to be separated (under IFRS 9) are considered as part of the insurance contract and accounted for under IFRS 17.

13.3. Are the IFRS 17 requirements on embedded derivatives different from those in IFRS 4?

The requirements may be different.

Paragraph 8 of IFRS 4 stated that, as *"an exception to the requirements in IAS 39, an insurer need not separate, and measure at fair value a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differs from the carrying amount of the host insurance liability."* This exception is not included in IFRS 17. This might be seen as a requirement to separate embedded derivatives of that kind, if they meet the conditions in paragraph 4.3.3. of IFRS 9.

In addition, the IFRS 4 implementation guidance (IG3 and 4) provided 20 examples of products, some with and some without embedded derivatives requiring separation. The IFRS 4 implementation guidance has not been included in the implementation guidance to IFRS 17. As a consequence, there may be a difference in the scope of embedded derivatives requiring separation. This might require an assessment based on the nature of individual contract types.

Experience of applying IFRS 4 showed that in many countries the majority of insurance products do not contain embedded derivatives which require separation. It is unclear yet whether the mentioned changes might have a different result.

13.4. Are there specific disclosure requirements for embedded derivatives?

For embedded derivatives that are not separated and so are part of an insurance contract, there are no additional specific disclosure requirements in IFRS 17. For reference in IFRS 4, paragraph 39(e) specifically required that information about the exposure to market risk be disclosed if such embedded derivatives are not measured and presented at fair value through profit or loss.

For embedded derivatives that are separated, the disclosure requirements are as set out in IFRS 17.

Chapter 14 – Contract Modifications and Derecognition

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

14.A. What does this chapter address?

This chapter considers the treatment under IFRS 17 of contract modification to insurance contracts, including reinsurance contracts, and de-recognition including on transfer to third parties.

It discusses what is a contract modification and which of these:

- result in the derecognition of the original contract and recognition of the modified contract as a new contract for a deemed premium; or
- can simply be treated as a change in estimates.

The chapter also describes:

- a possible approach for determining the deemed premium when the modification is treated as a cancellation and replacement of the original contract; and
- as well as their application under the premium allocation approach.

14.B. Which sections of IFRS 17 address this topic?

Paragraphs 72 to 77 provide guidance on this topic.

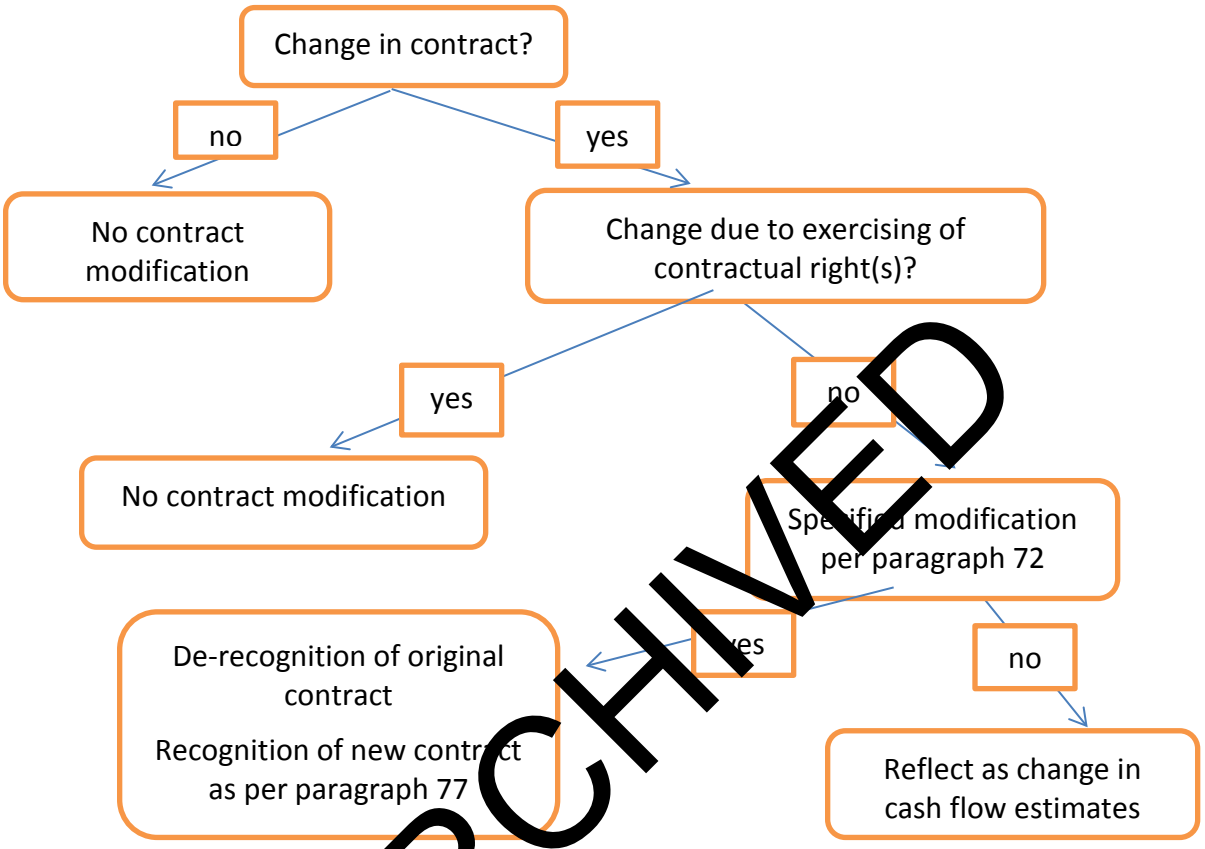
BC 306 and 316-322 also provide background on the subject.

14.C. What other IAA documents are relevant to this topic?

None

Overview

This flowchart is included to help in understanding whether or not there is a contract modification which needs to be accounted for. It is designed to be used in conjunction with the questions in this chapter.



What is a contract modification?

14.1. What is a contract?

Refer to chapter 1 "Classification of Contracts and Contract Boundaries".

14.2. How does IFRS 17 define a Contract Modification?

IFRS 17 defines a contract modification as a change to the legally enforceable terms of the contract, for example, either by agreement between the parties to the contract or by change in law or regulation (see paragraph 72). Note that the exercise of any rights or options available under the contract, by one or both parties, are not contract modifications (see paragraph 72) and form part of the expected cash flows of original contract.

14.3. What is a contract modification?

Examples of what is and is not a contract modification for IFRS 17 purposes are given below. These examples are not a complete or exhaustive list.

(a) The following are considered to be a contract modification (so long as it does not arise from an option available to either the insurer or policyholder) as they require the agreement of both insurer and policyholder to take affect (note, this does not include any requirement to notify the other party in order to exercise the option):

(i) an increase or decrease in the nature or level of benefits under the contract, note these could include changes to extend or reduce the period of cover under the contract (i.e., affect the contract boundary) – unless they arise from the exercise of an option under the contract, or they only effect coverage beyond the contract boundary (refer Chapter 1);

(ii) the addition or removal of benefits under the contract;

(iii) the addition or removal of coverages under the contract;

(iv) the addition or removal of options or guarantees available under the contract;

(v) any change to premiums;

(vi) any change of reinsurance contracts terms and conditions requiring the consent of both parties;

(vii) by change to contractual terms arising from change in regulation;

(b) The following are considered not to be a contract modification:

(i) the exercise of any options available to the policyholder under the terms of the contract (or law), within the contract boundary, that do not require the agreement of the insurer (this does not include any requirement to notify the other party in order to exercise), for example:

- an option to renew the contract under the terms of the contract without further underwriting;
- an option to surrender the contract or to cease paying premiums while still receiving benefits under the contract;
- exercise of a contractual right to suspend and later resume cover under the contract without a new risk assessment;
- an option to increase cover on renewal e.g., with consumer price index or at other times under the contract (e.g., guaranteed future insurance options) without further underwriting;
- contracts arising from guaranteed insurability options as these form part of the original contract terms and are neither a new contract nor a contract modification (e.g., guaranteed annuitisation option under a deferred annuity contract);

(ii) the exercise of any options available to the insurer under the terms of the contract (or law), within the contract boundary, that do not require the agreement of the policyholder (the need to notify the other party to exercise the option does not mean their agreement is required, unless they have right to refuse the exercise of the option), for example:

- changes to premium or benefits permitted under terms of the contract, law or regulation. Note:
  - if the policyholder has the right to terminate the contract upon such a change, this does not mean agreement of both parties is required for the insurer to exercise the right to make such changes, simply that it gives the policyholder rights. In both cases they can be exercised without the agreement of the other party and hence these are not contract modifications;
  - where the insurer has the right or practical ability to change the premium in such a way that the payment of that premium is outside of the boundaries of the contract (refer to chapter 1) then it creates a new contract which is to be measured as such.

14.4. How are changes that are not contract modifications treated?

Changes that are not contract modifications (see question 14.3) form part of the expected cash flows under the contract (see chapter 3) so long as they are within the contract boundary (see chapter 1). That is both when:

a) measuring it upon initial recognition under paragraphs 32 -35, paragraphs B61 and B62; and

b) upon subsequent measurement under paragraph 40.

14.5. What about the exercise of a contractual option to add features that is outside the contract boundary?

A special case may occur if there is a contractual right to add new features to the original contract which could be outside the contract boundary because the entity is able to reprice or underwrite the contract for the additional feature added at the time it is added.

IFRS 17 treats cash flows outside the contract boundary as relating to future insurance contracts (paragraph 35) and such a new feature might be eligible to be treated as a new contract.

The treatment of contractual options and their interaction with the contract boundary was discussed at the IASB May 2018 TRG meeting (see AP03 Cash flows within the contract boundary and the IASB Summary of the May TRG Meeting).

It was observed by the TRG, that unless the contractual option of itself, even before exercise, qualifies as a separate contract (see IASB Feb 18 TRG paper AP01 Separation of insurance components of a single insurance contract and IASB TRG summary for the

limited circumstances in which this may apply), then it is a contractual feature of the insurance contract. In that case it is included in measurement of the original contract to the extent it is with in the contract boundary.

The staff view was that:

- as the unit of account is the contract as a whole, the contract boundary depends on the substantive rights and obligations as a whole; and
- the ability to reprice a part (e.g., the feature being added on exercise of the option) does not mean that part has a different contract boundary.
- If the addition, upon exercise of the option, was able to be repriced at time of exercise, then the insurer would need to decide whether there was any contractual obligation that needed to be measured prior to exercise.

Also, it may not be practicable, where the new feature is not distinct (i.e., the cash flows of the new feature and the original contract are highly interrelated), to treat it as a separate new contract.

If not distinct, then the addition of new features that are outside of the contract boundary (e.g., because they can be underwritten at the time of exercise at an appropriate price for the change in insurance risk, if the alternative TRG view is taken) might be treated as a contract modification at the time of addition, as the ability to underwrite the new feature effectively means the consent of both parties is required. An example of such a feature is the reduction of payment limits (with risk assessment for the reduction) that occurs in German Health insurance.

If the contract modification is not a specified modification under paragraph 72, then paragraph 73 applies, i.e. the contract is not de-recognised and the changes in cash flows caused by the modification are treated as changes in estimates of fulfilment cash flows.

Specified Modifications

14.6. Which are the specified contract modifications that result in the derecognition of the original and recognition of the modified contract as a new contract?

These are those contract modifications specified in paragraph 72, ("specified contract modifications"). The discussion in the Basis for Conclusions (see BC317 – BC320) indicates that these criteria in paragraph 72 capture modifications that IASB sees as resulting in significantly different accounting treatment. For example, if the modified terms had applied at inception, they would have caused differences in the applicability of IFRS17, or the separation of components, or the contract boundary (only if substantially different), or the applicability of the measurement model of the original contract.

The specified criteria are such that had the contract had been written at inception as now modified, it would:

- not have been classified as an insurance contract (see chapter 1); or

- have been included in the different group from the one it was included in at initial recognition; or
- have a substantially different contract boundary; or
- have had different components separated, resulting in a different insurance contract for IFRS 17; or
- if the PAA was applied to the contract and it would not have qualified (see Chapter 7); or
- have qualified (or ceased to qualify) for treatment as an insurance contract with direct participation features.

14.7. How do contract modifications or the exercise of options available under the contract influence the contract boundary?

The contract boundary is re-assessed in each reporting period (see paragraph B64) and ends when the criteria of paragraphs 34 are fulfilled (see chapter 1).

14.8. What qualifies as a substantially different contract boundary for the purposes of paragraph 72?

The intent in setting the criteria in paragraph 72 was to capture those contract modifications that would result in a significantly different accounting treatment (see BC317-BC320) for the modified contract had the new terms always applied and only those contract modifications (see BC320).

This indicates that it is possible the criteria for assessing if the change in contract boundary is substantial, if it had occurred at inception, might impact on the accounting treatment.

A contract modification that changes the contract boundary in such a way that, if the contract had been written at inception as modified, it would:

- have not qualified for the PAA, when it was being accounted for under the PAA; or
- would have been included in a different group

is clearly a contract modification that results in a significantly different accounting treatment, as it is captured under the other criteria in paragraph 72.

Other contract boundary changes that possibly could be considered to result in a significantly different accounting treatment include but are not limited to:

- a change such that the renewal of the contract is now outside the contract boundary (e.g., the modification gives the insurer the right to reprice the contract at renewal) so that the contract becomes eligible for the PAA upon renewal; or
- a change to the contract boundary that has a substantial effect on the contract's CSM release pattern.

Note that, if the relevant criterion is the impact of the change in contract boundary the impact of any other modifications to the contract on the contract's CSM release pattern would, if material, need to be excluded from this assessment. For example, if the criterion is simply the change in the contract boundary itself, then a change that increased or decreased the contract boundary by 50% or more at inception of the contract, might be a substantial change, but one that changed it by 20% or less might not be a substantial change, e.g.,

- The extension of a contract term from 20 years to 40 years might be substantial; and
- The extension of contract that originally provided coverage from age 30 up to age 60 to age 65 might not be substantial.

It should be noted that these examples are for illustrative purposes only and that every case needs to be considered on its own merits.

Accounting for specified contract modifications

14.9. How are specified contract modifications accounted for?

The entity:

(a) derecognises the contract being modified from the group to which it was allocated at inception by:

- setting the contribution of its fulfilment value, including the risk adjustment and incurred claims, to the group to zero (paragraph 76 (a));
- adjusting the number of coverage units for expected remaining coverage (paragraph 76(c));
- adjusting the CSM of the group to the extent required by paragraphs 44(c) and 45(c) for the difference between (paragraph 77(a)):
  - the reduction in fulfilment value of the group from setting that for the contract prior to modification to zero (paragraph 77(a)(i)); and
  - the premium it would have charged for a new contract issued at the date of contract modification with equivalent terms, net of any additional premium charged for the modification (paragraph 77(a)(iii));
- per paragraphs 44(c) and 45(c), the CSM can only be adjusted to the extent that the adjustment does not reduce the CSM below zero, except in the case of reinsurance held. If there is a loss component already, paragraphs 44(c)(ii), 45(c)(iii) and 50(b) apply;

and

(b) recognises the modified contract as a new contract as at the date of modification under IFRS 17 assuming the net equivalent premium noted above was paid as at the date of modification (see paragraph 77(b)).

14.10. If the insurer does not have contracts with equivalent terms, how is the premium determined?

The premium is the price that the entity would have charged the policyholder if it had entered into a contract with equivalent terms at the date of the actual modification (see paragraph 77(a)(iii)).

The assumptions used in determining the premium would usually be consistent with those used in determining the liability arising from the modified contract at the date of actual modification, except for the CSM.

For example, the premium might be determined as the sum of:

- the fulfilment cash flows (the unbiased expected present value of the future cash flows, excluding the premium being determined and including any taxes on the premium, acquisition costs for the modified contract, and an adjustment for risk);
- any other elements not included in fulfilment cash flows under IFRS 17 that the entity would normally include in setting premiums, e.g., general overheads and costs not directly attributable to a portfolio of insurance contracts and charge for capital; and
- the CSM after allowing for any elements not included in fulfilment cash flows, that reflects the entity's current approach to profit targets when pricing for similar business.

Note, this may not be the same as the fair value of the modified contract, and the premium possibly could differ from fair value because:

(a) it uses entity-specific assumptions for some inputs, including the degree of risk aversion, whereas fair value typically uses market participant assumptions in all cases;

(b) it excludes the entity's own non-performance risk, whereas fair value would include the entity's own non-performance risk; and

(c) it includes the entity's targets for CSM, whereas fair value includes no such margin, although fair value implicitly includes a current value for any additional margin that market participants would require.

Other contract modifications

14.11. What other types of contract modifications are there?

Apart from specified contract modifications, as per paragraph 72, there are other contract modifications. Examples could include:

- Addition or removal of benefits, where they do not cause the contract to fall into another portfolio and hence different group;
- Increase or reduction in benefits, where they do not change grouping;

- Changes to what is covered, e.g., an extension or renovation under home insurance, or a new car under motor insurance; or
- Extension or reduction of the contract term, with no substantial change in benefit levels, provided this does not materially change the contract boundary or change eligibility for PAA.

14.12. How are other contract modifications accounted for?

Contract modifications not specified in paragraph 72 are accounted for by treating the resulting changes in the fulfilment cash flows (i.e., expected cash flows, risk adjustment) as a change in estimates as per paragraphs 40-52 (see paragraph 73).

Derecognition

14.13. When can contracts be derecognised?

Contracts can be derecognised only when:

- A specified contract modification occurs (see question 14.6 above), in this case the modified contract is treated as a new contract which assumes all obligations arising from the contract pre and post modification; or
- A contract is transferred to a third party (see paragraph 77 and question 14.14 below), this applies only when the contract is transferred as a whole including any obligation for incurred claims arising from past coverage, otherwise the contract in full has not been extinguished and cannot be derecognised as per paragraph 74; or
- All obligations under the contract are extinguished (see question 14.15 below). This includes not only the liability for future coverage but also for incurred claims arising from past coverage (see paragraph 74(a)).

14.14. How are contracts that are transferred to a third party derecognised?

In a similar way to the derecognition of a contract upon a specified contract modification (per the paragraph 77 criteria) that is the contract being transferred is derecognised from the group to which it was allocated at inception by:

- setting the contribution of its fulfilment value (including the risk adjustment and incurred claims) to the group to zero;
- adjusting the number of coverage units (see paragraph 76(c))
- adjusting the CSM of the group for the difference between:
  - the reduction in the insurance contract liability of the group from setting that for the contract prior to modification to zero; and
  - the premium charged by the third party for transfer of the contract.

14.15. How are contracts derecognised other than due to a specified contract modification or transfer to a third party?

In a similar way to the derecognition of a contract upon a specified contract modification (per paragraph 72 criteria), that is the contract being transferred is derecognised from the group to which it was allocated at inception by:

- setting the contribution of its fulfilment value (including the risk adjustment and incurred claims) to the group to zero;
- adjusting the number of coverage units (paragraph 76(c));
- adjusting the CSM of the group for the reduction in fulfilment value of the group from setting the fulfilment value relating to future service for the contract being derecognized to zero.

14.16. What if only the obligation for future coverage is transferred to a third party?

In this case, the contract does not qualify for derecognition under paragraph 77 and is treated as a contract modification.

Application to reinsurance and premium allocation approach

14.17. How are modifications to reinsurance contracts accounted for?

Reinsurance contracts are insurance contracts and the modifications to them are accounted for in the same way as for other insurance (paragraph 4), see also chapter 9.

14.18. How do modifications to underlying insurance contracts affect the subsequent measurement of the reinsurance contract?

To the extent that they change the expected cash flows under the reinsurance contract, they are:

- reflected in the measurement of the reinsurance contract (as per paragraphs 40-46 and 60(a)); and
- not reflected in the CSM of the reinsurance contract to the extent that they do not adjust the CSM of the underlying group of insurance contracts (see paragraph 66(c)) and relate to future service.

14.19. How are contract modifications and derecognition accounted for under the PAA?

The requirements of paragraphs 73, 76 and 77 presume that the contract is being measured under the GMA. Where PAA applies to a contract (and in the case of a contract modification it continues to qualify for PAA), one possible interpretation is that they have no effect for PAA contracts.

Another possible approach is to apply the requirements of paragraphs 73, 76 and 77 appropriately modified for PAA, e.g.,

(a) For non-specified contract modifications, as per the answer to Q14.12 and Q14.15, (because a change in estimates under PAA only impacts the liability for incurred

claims as per paragraph 40 (b)) this element would reflect this change if appropriate. However, if the contract modification where to:

(i) cause the group of which it is a part to be viewed as onerous, paragraphs 57 and 58 would apply and liability for remaining coverage would also change as per these paragraphs; or

(ii) cause the premiums received to change then this would be reflected in the liability for remaining coverage as per paragraph 55.

(b) For specified contract modifications, the answer to Q14.9 applies, modified for PAA as follows:

(i) de-recognises the modified contract from the group of which it is part by setting the contribution of its carrying value to the group including liability for incurred claims to zero, consistent with paragraph 76 (a); and

(ii) recognises the modified contract as a new contract as at the date of modification under IFRS 17 assuming the premium it would have charged for a new contract issued at the date of contract modification with equivalent terms, net of any additional premium charged for the modification (paragraph 77(a)(ii)) was received as at the date of modification (paragraph 77(b)).

(c) When derecognising a contract, the answer to Question 14.15 applies, modified for PAA as per (b) (i) above.

(d) When derecognising a contract upon transfer to another party, the answer to Question 14.14 applies, modified for PAA as per (b)(i) above.

14.20. What if a modified contract was part of an onerous group?

If the modification is not specified in paragraph 72, then paragraph 73 applies and the changes in estimates of fulfilment cash flows are treated in accordance with paragraphs 50 and 51 in the same way as any other subsequent change in fulfilment cash flows under IFRS 17.

If the modification is specified in paragraph 72, then it is treated as per paragraphs 74-77, (see question 14.9) and there is no CSM to be adjusted in respect of the onerous group to which the contract was allocated at inception. However, as noted in question 14.9 it is allocated to the loss component as required by paragraphs 44(c)(ii), 45(c)(iii) and 50(b) unless measured under PAA.

Chapter 15 – Measurement, Presentation and Disclosure

Before consulting this chapter, be sure to read the introduction to this IAN, particularly the sections on references to IFRS 17, materiality and proportionality.

15.A. What does this chapter address?

This chapter considers the general requirements for presentation of financial information under IFRS contained in IAS 1 as well as the specific additional requirements in IFRS 17. It also provides general comments on the disclosures required to explain the presentation such as the required reconciliations. This chapter discusses the additional requirements of IFRS 17, what constitutes revenue and expenses, how experience variances are presented, what is to be reported in the statement of financial performance versus other comprehensive income, the level of aggregation to be used in presentation and disclosure, and required reconciliations. This chapter also covers changes in presentation permitted or required when using the premium allocation approach (PAA), but differences in presentation for the variable fee approach (VFA) are covered in the chapter 8 of this IAN on contracts with participation features.

This chapter is split into three sections discussing i

- Section A – Measurement
- Section B – Presentation and
- Section C – Disclosures

However, it should be noted that as there is much overlap between these subjects one will need to read the whole chapter to appreciate the subject in total. These three sections address the following subjects:

- Overview of IFRS 17 presentation;
- Statement of financial position;
- Statement of financial performance;
- Presentation: timing of cash flows;
- Presentation of acquisition costs and other insurance expenses;
- Presenting other features of IFRS 17 measurement;
- Presentation for different types of entity; and
- Interim reporting, disclosures and transition to IFRS 17.

15.B Which sections of IFRS 17 address this topic?

Paragraphs 78 to 132 and B120 to B137 set out the requirements on this topic.

Paragraphs BC328 to BC366 also provide background on the subject.

15.C What other IAA documents are relevant to this topic?

None

Overview of IFRS Presentation

15.1. What is meant by "presentation" in IFRS 17?

IFRS 17 sets out the items that will be presented in the statement of financial position (a term used in IFRSs for balance sheet) in paragraphs 78 to 79 and in the statement(s) of financial performance (a term used in IFRSs for the income statement or statement of profit or loss) in paragraphs 80 to 92 and B120 to B136. In addition to the profit or loss, the statement of financial performance also includes changes in the statement of financial position not included in the profit or loss, which are referred to as "other comprehensive income" or "OCI".

Insurance contracts are not included in IFRS 17 presentation that relate to periods after the date of derecognition of those contracts.

Below is an illustrative example statement of financial position and statement of comprehensive income under IFRS 17 taken from selected illustrative disclosures published by EY. This illustrative example reflects certain options an entity might use but others may well choose other options.

Statement of financial position

In €000	Notes	As at 31 December 2021	As at 31 December 2020 *restated*	As at 1 January 2020 *restated*	
					IAS 1.10(a) IAS 1.51 (b)(c)
Assets					*IAS 1.51(d),(e)*
Cash and cash equivalents		180	57	892	*IAS 1.54(i)*
Equity and debt instruments at fair value through profit or loss	9	6,597	5,452	4,517	*IAS 1.54(d), IFRS 7.8(a)*
Debt instruments at fair value through other comprehensive income	10	11,356	10,687	9,525	*IFRS 7.8(h)*
Debt instruments at amortised cost	11	1,036	987	940	
Insurance contract assets	12	102	92	83	*IFRS 17.78(a)*
Reinsurance contract assets	12	2,880	2,811	2,382	*IFRS 17.78(c)*
Deferred tax assets		-	-	-	*IAS 1.54(o)*
Other assets		-	-	-	*IAS 1.55*
Total assets		**22,151**	**20,086**	**18,339**	
Liabilities					
Current tax liabilities		10	175	22	*IAS 1.54(n)*
Insurance contract liabilities	12	17,53	16,618	15,730	*IFRS 17.78(b)*
Reinsurance contract liabilities	12	25	24	22	*IFRS 17.78(d)*
Deferred tax liabilities		43	46	50	*IAS 1.56,IAS 1.54(O)*
Other payables		10	190	173	*IAS 1.55*
Total liabilities		**18,048**	**17,053**	**15,997**	
Equity					
Issued capital		150	150	150	*IAS 1.54(r), IAS 1.78(e)*
Retained earnings		3,873	2,835	2,141	*IAS 1.54(r), IAS 1.78(e)*
Fair value reserve		268	126	152	*IAS 1.54(r), IAS 1.78(e)*
Insurance/reinsurance finance reserve		(188)	(78)	(101)	*IAS 1.54(r), IAS 1.78(e)*
Total equity		**4,103**	**3,033**	**2,342**	
Total liabilities and equity		**22,151**	**20,086**	**18,339**	

The accounting policies and Notes on pages 11 to 81 form part of, and should be read in conjunction with, these financial statements.

Statement of profit or loss and other comprehensive income

For the year ended 31 December 2021

In €000	**Notes**	**2021**	**2020 *restated***	*IAS 1.81A, IAS 1.9(d), IAS 1.10(b), IAS 1.51(b)-(e) IAS 1.29, IAS 1.32 IAS 1.104, IAS 1.46, IAS 1.45*
Insurance revenue	6	2,581	2,293	*IAS 1.82(a)(ii), IFRS 17.83*
Insurance service expense	12	(1,541)	(1,411)	*IAS 1.82(ab), IFRS 17.84*
Insurance service result before reinsurance contracts held		**1,040**	**882**	
Allocation of reinsurance premiums	7	(448)	(546)	*IFRS 17.86*
Amounts recoverable from reinsurers for incurred claims		279	348	*IFRS 17.86*
Net expense from reinsurance contracts held	7	**(169)**	**(198)**	*IAS 1.82(ac), IFRS 17.82*
Insurance service result		**871**	**684**	*IFRS 17.80(a)*
Interest revenue calculated using the effective interest method		831	622	*IAS 1.82(a)(i)*
Other interest and similar income		56	299	
Net fair value gains/(losses) on financial assets at fair value through profit or loss		104	(14)	*IFRS 7.20(a)(i)*
Net fair value gains/(losses) on derecognition of financial assets measured at fair value through other comprehensive income		6	-	*IAS 1.82(aa)*
Impairment loss on financial assets		(5)	(2)	*IAS 1.82(ba)*
Net foreign exchange (expense) / income		(50)	22	
Total investment income	8	**1,252**	**927**	
Insurance finance expenses for insurance contracts issued	8	(742)	(673)	*IAS 1.82(bb), IFRS 17.87*
Reinsurance finance income for reinsurance contracts held	8	98	119	*IAS 1.82(bc), IFRS 17.82*
Net insurance financial result		**(644)**	**(554)**	
Other income and expense		(210)	(191)	
Profit before tax		**1,269**	**866**	
Income tax expense		(231)	(172)	*IAS 1.82(d), IAS 12.77*
Profit for the year		**1,038**	**694**	*IAS 1.81A*
Other comprehensive income				
OCI to be reclassified to profit or loss in subsequent periods				*IAS 1.82A(a)(ii)*
Change in fair value of financial assets	8	179	(35)	*IFRS 7.20(a)(viii)*
Amount reclassified to profit or loss	8	(1)	2	*IFRS 7.20(a)(viii)*
Debt instruments at fair value through other comprehensive income	8	**178**	**(33)**	
Insurance finance expenses for insurance contracts issued	8	(194)	38	*IFRS 17.88(b), 89(b)*
Reinsurance finance income for reinsurance contracts held	8	56	(9)	*IFRS 17.82*
Net insurance financial result		**(138)**	**29**	
Income tax relating to items that may be reclassified		(8)	1	
Total other comprehensive income		**32**	**(3)**	
Total comprehensive income		**1,070**	**691**	

The accounting policies and Notes on pages 11 to 81 form part of, and should be read in conjunction with, these financial statements.

The following commentary is based on GMA. Other treatment may apply for PAA and this is discussed in the discussion below.

The insurance service result (paragraphs 83-86 and B120-B127), includes:

- Insurance revenue, comprising the release of expected claim and other expense cash flows, release of CSM and release of risk adjustment for the period; and
- Insurance service expenses, comprising actual incurred claims and other expenses, including acquisition expenses, for the period.

Insurance finance income or expenses (refer paragraphs 87 – 92 and B128 – B136), for the effect of the time value of money and financial risk, includes:

- Investment income earned on assets during the period, and
- The effect of discounting of the expected future cash flows.

The insurance service result can be broadly thought of as the component of the result relating to claims and underwriting risk while insurance finance income or expenses can be thought of as the component relating to financial and market risk.

The insurance finance income and expenses can be disaggregated between the profit or loss and other comprehensive income (OCI) in order to reduce accounting mismatches (refer paragraphs 88(b) and B129 – B130).

Section A – Measurement of line items in the statement of financial performance

This section considers the general requirements for measurement of key line items for insurance contracts in the statement of financial performance in IFRS 17. It covers changes in presentation permitted or required when using the PAA, but differences in presentation for the VFA are covered in the chapter 8 of this IAN on contracts with participation features.

15.2. How is insurance revenue, gross of reinsurance, measured?

IFRS 17 paragraph 83 states that "[…]*Insurance revenue shall depict the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services.[…]*"

The measurement of insurance revenue is set out in paragraphs B120 to B127. Some of the key themes from these paragraphs are discussed below, but it is important to refer to the specific requirements in IFRS 17 as well.

In effect, insurance contract revenue represents the value of the services that the entity expected to provide during the reporting period. This includes amounts in the statement of financial position at the start of the reporting period for the value of future coverage, including the release of CSM and risk adjustment, which will not be included in the statement of financial position at the end of the reporting period as the related coverage is provided in the reporting period. This component of the revenue is based on a view of

what services would be provided in the financial reporting period that were already included in the opening balance sheet.

It is necessary to also include revenue in respect of coverage provided by insurance contracts which were recognised for the first time during the financial reporting period and provided coverage during that period. The amount of this revenue is based on the value of the contracts at initial recognition and the portion of coverage and other services provided by those contracts during the reporting period.

Over the lifetime of the contract, the total revenue is the sum of the premiums received, adjusted for a financing effect and excluding investment components. It is still the premium but, for long term business, recognised in a very different way and timing compared to most accounting bases applying prior to IFRS 17.

Insurance revenue related to insurance acquisition cash flows is measured by allocating a portion of premiums related to recovering these cash flows to each reporting period. This allocation is based on the passage of time. An equal and offsetting amount is recognised in insurance service expenses (see paragraph B125).

Under the PAA, insurance revenue is measured as the expected premium receipts adjusted to reflect the time value of money and the effect of financial risk where significant (excluding any investment component) allocated to the period. In addition, paragraph 56 specifies that the time value of money need not be reflected if the time between premium receipt and provision of coverage is one year or less. The allocation is based on the passage of time, unless the expected pattern of release of risk differs significantly from the passage of time, in which case it should be allocated based on the expected timing of incurred insurance service expenses (see paragraph B126). Liability for remaining coverage is defined in paragraph 40(a) and Appendix A. Paragraph 55 specifies the liability for remaining coverage for the PAA. See also chapter 7.

The impact of reinsurance is discussed in question 15.9.

15.3. What is included in insurance service expenses?

The items included in insurance service expenses are identified in paragraph 103b as:

i. Incurred claims (excluding investment components) and other incurred insurance service expenses;

ii. amortisation of insurance acquisition cash flows;

iii. changes that relate to past service, i.e., changes in fulfilment cash flows relating to the liability for incurred claims; and

iv. changes that relate to future service, i.e., losses on onerous groups of contracts and reversals of such losses.

As discussed in question 15.34 amortisation of insurance acquisition cash flows are equal and offsetting to the amount included in insurance revenue.

The term “liability for incurred claims” is defined in paragraph 40(b) and in Appendix A.

15.4. What is the insurance service result?

Paragraph 80 details that the insurance service result comprises the insurance revenue and insurance service expenses, which are presented excluding investment components. Insurance revenue and insurance service expenses are discussed in the previous two questions and the exclusion of the investment component is discussed in the question below.

15.5. What does it mean to exclude the investment component from the presentation of the insurance revenue and insurance services expenses?

This question is primarily interested in the presentation on investment components that are not distinct. Appendix A defines investment components as "*The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.*" The paragraph below briefly explains the treatment of distinct investment components, which are excluded from revenue and expenses and the subsequent paragraph clarifies what are investment component under IFRS 17. It will be necessary to identify which insurance contracts have investment components that are not distinct but need to be presented separately.

The IASB has separate financial reporting standards for financial instruments (IFRS 9) and contracts with customers (IFRS 15). Insurance contracts typically combine elements of the characteristics of both financial components and service components. In paragraph IN4 the IASB explains, in its rationale for implementing IFRS 17, long-term and complex insurance risks are difficult to reflect in the measurement of insurance contracts, are not typically traded in markets and may include a significant investment component which, poses further measurement challenges. Paragraph IN7 explains that IFRS 17 results in the liability for a group of insurance contracts relating to remaining future service under those contracts being measured broadly consistent with IFRS 15 except that the liability often includes an investment component typically not in contracts within the scope of IFRS 15. In IFRS 17 reporting entities are required to distinguish between the financial and non-financial performance from insurance contracts.

An investment component of an insurance contract is the amounts the entity is required to pay to the policyholder even if the insured event does not occur (Appendix A). For example, where there are guaranteed benefits, some profit commission arrangements or where there is a fund that is repaid to the policyholder if it is not required to settle claims or pay benefits. For example, guaranteed amounts or repayments of funds payable by the entity when a contract lapses or is surrendered, may meet the IFRS 17 definition of investment components as the payments do not depend on an underlying insured event.

Distinct investment components, will already have been separated from insurance contracts and reported for in accordance with IFRS 9 (see paragraphs 10-12 of IFRS 17). This question is referring to investment components that are not distinct. Paragraph 13 makes clear that later references to investment components in IFRS 17 refer to treatment of indistinct investment components that have not already been separated and reported as if they were separate investment contracts.

IFRS 17 requires that insurance service revenue and insurance service expenses exclude investment components (refer to paragraphs 42(b), 55(b)(vi), 84, 85, 103(b)(i)), B120, B123(a)(ii), B124(a)(ii)). Paragraph 103 (c) requires that investment components excluded from insurance revenue and insurance service expenses are disclosed separately in the reconciliations.

15.6. How is the investment component of an insurance contract in scope of IFRS 17 measured?

It is not necessary to explicitly measure investment components in order to be able to exclude them from insurance revenue and insurance service expenses. The requirement is only to exclude the amounts identified as arising from investment components at the reporting date. This is explained in BC34.

IFRS 17 identifies the determination of these investment components as a significant judgment and requires disclosure of the inputs, assumptions and estimation techniques used (see paragraph 117(c)(iv)).

There is a specific requirement to allow for the difference between the expected and actual value of investment components that become payable in the period, in the CSM (paragraph B96(c)). See chapter 6 for further information on the CSM.

At the time of drafting, it seems likely that reporting entities will need to define a basis for measuring investment components of insurance contracts being reported under IFRS 17.

15.7. What is the insurance finance income or expense and how can it be presented in the statement of financial performance?

Paragraph 87 defines insurance finance income or expenses as the change in insurance contract liabilities arising from the effect of the time value of money or changes in the time value of money (which means the unwinding of the discount rates applied to the fulfilment cash flows, changes in the discount rates applied to the fulfilment cash flows and the accretion of interest on the CSM) and the effect of financial risk or changes in financial risk.

Groups of contracts with direct participation features that are onerous, may experience gains or losses due to the time value of money or financial risk that would otherwise result in an adjustment to the CSM if the contracts were profitable. These gains or losses arise when the carrying amount of the CSM is exceeded by the entity's share of a decrease in the fair value of the underlying items or increases in the fulfilment cash flows relating to future service (or when these amounts reverse due to the entity's share of an increase in the fair value of the underlying items or decrease in the fulfilment cash flows relating to future service). These gains or losses are excluded from the insurance finance income or expenses and reported in the insurance service expenses.

An accounting policy choice needs to be made between reporting insurance finance income or expenses entirely in profit or loss, or splitting it between profit or loss and OCI. The reasons for allowing this choice of presentation are considered in chapter 3 on discounting.

If an entity chooses to split insurance finance income or expenses for a portfolio of insurance contracts between profit or loss and OCI, the standard sets out the presentation requirements in two categories:

1. Contracts with direct participation features for which the entity holds the underlying items; and
2. All other contracts.

The basis for determining the discount rate that applies when calculating the insurance finance expense is covered in chapter 3.

15.8. When do you not need to present insurance finance expense?

Paragraph 56 indicates that under the PAA an "*entity is not required to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk if, at initial recognition, the entity expects that the time between providing each part of the coverage and the related premium due date is no more than a year.*" In this case no insurance finance expense calculation is needed.

15.9. Are ceded reinsurance premiums and recoveries included in revenue or as negative expenses?

Insurance contract revenue is calculated only in relation to groups of insurance contracts issued (paragraph 83).

Income and expenses from reinsurance contracts held is presented separately in the insurance service result from expenses and income from insurance contracts issued (paragraph 82). An entity may present income and expenses from a group of reinsurance contracts as a single amount or 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 (paragraph 86), excluding investment components (paragraph 85).

If the income and expenses from reinsurance contracts held are presented separately, paragraph 86 sets out that other reinsurance cash flows contingent on claims on the underlying contracts are presented as part of the claims that are expected to be reimbursed. However, other reinsurance cash flows that are expected to be received that are not contingent on the claims to the underlying contracts, e.g., some types of ceding commissions, are presented as a reduction to the premiums paid to the reinsurer.

Presentation: timing of cash flows

15.10. How are future premiums on existing insurance contracts allowed for in revenue, for example, instalment premiums, adjustment premiums and reinstatement premiums?

Paragraph B124 sets out that insurance revenue is for the reduction in the liability for remaining coverage because of services provided in the period. Consequently, only future premiums in respect of service provided in the period would be included in revenue for that period. This may include premiums that have fallen due but have not yet been received, for example, from brokers where balances are settled quarterly or where

adjustment premiums are paid at the end of the coverage period relating to changes in exposure across the entire reporting period.

Future premiums, such as instalment premiums and reinstatement premiums, may relate to the provision of future coverage, not services provided in the period so will be included in the valuation of insurance contracts but are not included in revenue until the services are provided. This means that the value of premiums receivable will be recognised in the statement of financial position based on when those premiums will be received as they are within the contract boundary for insurance contracts within the scope of IFRS 17 but will not be included in the statement of financial performance until a subsequent reporting period when the services related to those premiums have been provided.

Future premium collections in some instances relate to coverage provided in the past, such as for retrospectively rated contracts and audit premiums found in some non-life policies. In that case, these future premiums might have already been reflected in a past income statement while still impacting the current statement of financial position.

Scope, recognition and contract boundary considerations are covered in chapter 1.

15.11. How are premiums already paid and premiums to be paid in the future in relation to currently held ceded reinsurance contracts shown in the statements of financial position and financial performance?

Premiums already paid to reinsurers are in the past so are not included in the valuation of reinsurance contracts held in the statement of financial position.

Future premiums due to be paid in respect of currently held reinsurance contracts that meet the recognition requirements and are within the contract boundary are included in the valuation of reinsurance contracts in the statement of financial position. They will be included in insurance expense in the statement of financial performance when the services are provided by the reinsurer which may be in a subsequent reporting period.

15.12. How is the impact of unexpected policy terminations determined and reflected in the insurance revenue?

Under the general model**,** paragraph B124 sets out that insurance revenue is for the reduction in the liability for remaining coverage because of services provided in the period.

B124a indicates that revenue includes "*insurance service expenses incurred in the period (measured at the amounts expected at the beginning of the period)*". Therefore, insurance revenue reflects policy terminations expected at the beginning of the period and will not reflect unexpected policy terminations that occur during the period. If the change in the terminations changes the expected cash flows for future coverage then this adjusts the CSM.

If the unexpected terminations change the entity's view of risk which leads to a change in the valuation of the risk adjustment during the reporting period, this may change the amount of risk adjustment included in insurance revenue. If the change in the terminations changes the valuation of the risk adjustment for future coverage then this

adjusts the CSM, see chapter 5, which may affect the amount of CSM included in revenue in the period.

Unexpected termination in a reporting period may lead to changes in the assumption for terminations in respect of future coverage. The impact of changes to the assumptions for future terminations on the valuation of insurance contracts that do not result in an adjustment to the CSM (e.g., when the impact is a further loss on a group of onerous contracts where the is no CSM) would be presented as an insurance expense in the period when the assumptions are updated but are not included in insurance revenue.

15.13. How is the impact of unexpected policy terminations determined and reflected in the insurance expense?

To answer this question, it is necessary to consider separately the impact of the unexpected policy terminations on the actual cash flows in the period and whether this changes the assumptions for the expected future cash flows for current service (i.e., the liability for incurred claims) and the expected future cash flows for future service (i.e., the liability for remaining coverage).

Assumptions about the number of policy terminations impact the likelihood of expected future cash flows and are taken into account in the timing and amount of cash flows for calculating the time value of money and the release of the CSM, whilst uncertainty about the level of future policy terminations is reflected in the risk adjustment.

Presentation of changes to actual cash flows in the reporting period

Where the level of policy terminations is different to that expected in the reporting period, the impact of the actual number of policy terminations will be reflected in the actual cash flows in the reporting period, which are included in the insurance expense for that period.

Presentation of changes to expected future cash flows for the current or past coverage periods

If the difference in actual policy terminations compared to those expected also leads to a change in the estimate of the fulfilment value for future cash flows for the liability for incurred claims (i.e., where the coverage has already expired), then the change in the valuation of the insurance contracts due to the change in assumptions for terminations is included in insurance service expense.

Presentation of changes to expected future cash flows for future coverage

Where the change in the valuation of insurance contracts relates to future coverage, the CSM may be adjusted. See chapter 6 on the CSM for when and how changes in assumptions may lead to a change in the CSM. If the impact of the changes in assumptions in relation to future policy terminations cannot be offset by adjusting the CSM (i.e., because it relates to the current period and not future coverage), then the value of that impact of the change in assumptions is included in insurance expense.

Disclosure of changes in termination rates

There is no explicit requirement to present or disclose the impact of changes in the number of policy terminations separately and these changes in assumptions may be combined with other assumptions changes. However, where policy terminations are a key assumption to the overall valuation, a reporting entity may consider that it would be appropriate to refer to changes in experience in the narrative disclosures describing the risk characteristics of the business (paragraphs 121-126) and consider whether it is appropriate to include the termination assumptions in the sensitivity analysis disclosures (paragraph 128-129). It may also be necessary to consider the significance of changes in termination rates when developing and explaining the reconciliations required in paragraphs 104-107.

Section B - Presentation

This section considers the general requirements for presentation of financial information under IFRS contained in IAS 1 as well as the specific additional requirements in IFRS 17. It also provides general comments on the disclosures required to explain the presentation such as the required reconciliations.

15.14. What are the general principles for IFRS presentation?

The general principles for presentation of financial statements under IFRS are set out in IAS 1 *Presentation of Financial Statements*, and these also apply to insurance contracts. In addition, IFRS 17 includes specific principles that only apply to insurance contracts. To understand the presentation requirements for insurance contracts under IFRS 17, it is necessary to consider IAS 1.

Paragraph 10 of IAS 1 sets out what a complete set of financial statements comprises. The key statements referred to are:

- The statement of financial position, which is traditionally referred to as the balance sheet under other reporting bases, and
- The statement of financial performance, which is also referred to as the statement of profit or loss and OCI (in IAS 1).

The statement of financial performance has three parts.

1. The top part presents sources of income and expenses that are included in profit or loss and ends with the assessment of profit or loss for the period.
2. Below this is presented sources of OCI that do not contribute to profit or loss.
3. Both these parts contribute to a total assessment of "comprehensive income" for the reporting period at the bottom of the statement.

IE185 includes an example of this presentation. While helpful for showing the three parts described above, this example is only intended to illustrate the amounts recognised as part of the insurance service result and not presentation requirements. For more details

on the presentation requirements see examples 3 and 9 of the IASB's illustrative examples.

Amounts included in OCI typically include items that affect the financial position of the company but do not directly relate to the performance of the business in the reporting period, for example, some unrealised gains on financial investments. In some cases there are options for the reporting entity to elect whether performance is reported in OCI or in profit/loss. In relation to insurance contracts, companies can choose in their accounting policies whether to show movements in the value of insurance contracts arising from changes in the current discount rates in the reporting period in profit or loss or as OCI. Paragraphs 82 and 83 of IAS 1 set out what should be presented in profit or loss or in OCI. IAS 1 paragraph 89 requires that all items of income and expenses should be included in profit or loss unless an IFRS requires or permits otherwise. Paragraphs 90 to 96 of IAS 1 specify some items to be included in OCI. There is more specific guidance in individual standards, such as in and IFRS 17 for insurance contracts.

Usually it is not necessary for an actuary working on the valuation of insurance contracts to need to consider the presentation requirements set out in IAS 1 as the reporting entity's finance team will have considered how these presentation requirements will be met. However, it is important to be aware that the presentation requirement in IFRS 17 should not be applied in isolation but in the context of the overarching IFRS principles. IAS 1 makes numerous reference to the IASB's Conceptual Framework for Financial Reporting, (Conceptual Framework). This describes the basic concepts that underlie the preparation and presentation of financial statements for external users. The conceptual framework serves as a guide to the IASB in developing future IFRS and as a guide to resolving accounting issues that are not addressed directly in an IAS or IFRS or Interpretation.

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* is another overarching standard that may need to be considered when implementing and applying IFRS 17. In the absence of a standard or an interpretation that specifically applies to a transaction, management needs to use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable. In making that judgment, IAS 8 paragraph 17 requires management to consider the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the IFRS framework.

In developing accounting policies in relation to IFRS 17, the entity may want to consider the distinction between the need to make future changes to the estimation basis within the context of the company's relevant accounting policy and when it may be necessary to make future changes to the companies account policies, which would require restatement of prior year comparatives.

15.15. What principles of materiality apply to IFRS 17 presentation?

There is an IFRS Practice Statement on Making Materiality Judgements. Reporting entities should have a basis for setting materiality for each set of financial statements and the

same materiality criteria should be applied to the application of IFRS 17. In the first instance it would be appropriate to ask one's principal what level of materiality should apply.

Although IAS 1 refers to separating material classes of similar items, IFRS 17 contains several levels of aggregation and disaggregation requirements, which also need to be taken into consideration for the purposes of presentation and measurement (see question 15.16 below). Materiality for presentation applies at the level of items required to be presented in the statement of financial position and statement of financial performance, not at the more granular level required for measurement. This means that where an assumption has a non-material impact on one class of business it may be regarded as a non-material assumption. However, even if an assumption has a non-material impact on each of several classes of business, it may still be necessary to consider whether the combined impact of that assumption on the reported line items is material to determine whether the assumption itself is a material assumption.

15.16. What is the level of disaggregation for insurance contracts presentation?

As discussed in chapter 1, paragraphs 14-24 set out several requirements for the disaggregation of insurance contracts based on the definition of a portfolio; further segregation of onerous contracts from contracts that may become onerous in the future and from other contracts; and disaggregation of contracts issued more than one year apart. Similar principles also apply for reinsurance contracts held (paragraph 61). All these requirements apply to the measurement of insurance contracts and to reinsurance contracts held. Presentation and disclosures for insurance contracts and reinsurance contracts held does not necessarily need to be at this level of granularity. In particular, disclosures do not necessarily need to be at the insurance contracts group level as defined in paragraph 16. (For further information on the level of aggregation for measurement, please refer to chapter 5.)

Paragraph 78 requires that reinsurance contracts held are presented separately from insurance contracts issued and further that these two groups should be further subdivided between groups of contracts that are onerous and those that are not. As the valuation of insurance contracts takes into account all future cash flows including future premiums it is possible that insurance contracts may be valued as assets rather than liabilities when the future premium income expected exceeds the future benefit payments, claims payments and expenses — for example, during the early stages of the coverage for contracts with regular or instalment premiums.

Paragraph 82 requires that income and expenses from reinsurance contracts held be presented separately from the expenses or income from insurance contracts issued.

IAS 1 (paragraphs 29-31) requires that each material class of similar items is presented separately. Paragraph 96 of IFRS 17 provides examples of aggregation bases that might be appropriate for information disclosed about insurance contracts. Examples of aggregation bases that might be appropriate for information disclosed about insurance contracts are:

(a) type of contract (for example, major product lines);

(b) geographical area (for example, country or region); or

(c) *reportable segment, as defined in IFRS 8 Operating Segments*.

15.17. What is segment reporting?

Although IFRS 17 sets requirements for the level of aggregation of insurance contracts in paragraph 96, it also refers to the requirements for reporting segments under IFRS 8, which already applies to insurance entities reporting under IFRS. It is only mandated for entities and groups with listed debt or equity, or those filing for a listing (IFRS 8 paragraph 2).

The core principle in IFRS 8 is that an entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates. IFRS 8 applies to individual financial statements for an entity and to the consolidated financial statements for a group.

Operating segments are identified on the basis of internal reporting about components of the entity that are regularly reviewed by management in order to allocate resources to the segment and to assess its performance. Similarly, the amounts reported are to be the measures used for internal reporting for those purposes. Disclosure includes information about how the entity identifies its operating segments and the types of products and services from which each segment derives its revenues.

An actuary considering how to apply IFRS 17 may also wish to consider the entity's existing approach to reporting segments under IFRS 8 in order to consider the appropriate level of aggregation for insurance contracts in each component of the business.

Statement of financial position

15.18. What amounts are presented in the statement for financial position for insurance contracts?

As explained in the answer to question 15.16 above, IFRS 17 requires that groups of insurance contracts that are assets be presented separately from groups of insurance contracts that are liabilities. This is a change from IFRS 4 where, in some jurisdictions, insurance contracts are currently presented as one item. This may be operationally difficult as entities may not be set up to segregate the measurement of insurance contracts in this way when applying IFRS 17 for the first time.

"Insurance contracts" refers to all contracts issued by an entity that meet the IFRS 17 definition of an insurance contract (paragraphs 3-8), which includes reinsurance contracts issued and investment contracts with discretionary participating features. IFRS 17 also applies to reinsurance contracts held but IFRS 17 specifies where the requirements applying to reinsurance contracts held are different to those for insurance contracts issued. Please refer to chapter 9 on reinsurance.

Presentation of insurance contracts is after separating distinct investment components, distinct service components and, where required by IFRS 9, embedded derivatives (paragraphs 10-12), which are accounted for under IFRS 9 and IFRS 15.

Insurance and reinsurance contracts should be included in the statement of financial position when they meet the IFRS 17 recognition requirements (paragraphs 25-28 and 62), which are considered further in chapter 10, and subject to the requirements for modification and derecognition (paragraphs 72-77), which are considered further in chapters 1 and 14.

15.19. What amounts are presented in the statement for financial position for reinsurance contracts held?

As explained in the answer to question 15.16 above, reinsurance contracts held are to be presented separately from insurance contracts issued and reinsurance contracts that are liabilities are to be presented separately from those that are liabilities.

15.20. Can recoveries from ceded reinsurance be shown netted against insurance contract liabilities in the statements of financial position and financial performance?

No. Amounts in respect of reinsurance contracts held must be presented separately from amounts in respect of insurance contracts issued in the statements of financial performance and financial position and in the supporting disclosures required to explain these statements.

15.21. How are future cash flows that have fallen due but have not yet been received or paid shown in the statement of financial position (for example, premiums, claims, benefits, expenses and acquisition costs)?

The measurement of insurance contracts under IFRS 17 includes all expected future cash flows within the contract boundary. Hence, if these cash flows are expected to be received or paid, they would be included in the liability for remaining coverage, or possibly the liability for incurred claims for situations such as retrospective premium adjustments or audit premiums for certain non-life policies.

If there is a risk the cash flows may not be received the probability-weighting for those cash flows should be adjusted to reflect the likelihood of receipt.

Under PAA, only premiums received are included in the liability for remaining coverage. Hence if the premium is due but not received, this would not be included in the liability measurement.

This may represent a significant change from previous financial reporting bases. Typically, local reporting bases for long term insurance contracts have included the value of the insurer's rights to future premiums in the valuation of the insurance contracts. In contrast, for non-life insurance business where unearned premium reserves are held, the unearned premium component of the technical provisions is often based on the total premium expected to be received, regardless of whether it has been received or not, and the portion of the premiums expected to be received in the future is presented as a receivable. Similarly, the reinsurer's portion of unearned premiums is based on the total

premiums expected to be paid including amounts not yet paid where the latter are presented in the liability for payables.

15.22. How are cash flows paid for services not yet received shown in the statement of financial position? (For example, reinsurance premiums paid for cover that has not yet expired?)

The IFRS 17 measurement basis for amounts presented in the statement of financial position is a prospective cash flow basis. Cash flows already completed are not included in the measurement of insurance contracts issued or reinsurance contracts held.

Statement of financial performance

15.23. What line items are required in the statement of financial performance?

Paragraph 80 requires that, for insurance contracts, the entity includes the following line items in the statement of financial position:

- Insurance revenue;
- Insurance service expenses;
- Insurance service result (comprising the two items above); and
- Insurance finance income and expenses.

Presenting other features of IFRS 17 measurement

15.24. When is the value of options and guarantees and changes in the values of options and guarantees presented in the statements of financial position and financial performance?

Paragraph 11(a) requires embedded derivatives to be separated from host contracts and accounted for under IFRS 9. For all embedded derivatives that are not separated from the host contract, these are measured and presented under IFRS 17 and included as part of the fulfilment cash flows (see paragraph B65(d)).

15.25. When and where is the additional value for onerous contracts presented in the statement for financial position?

For all insurance contracts meeting the IFRS 17 recognition requirements at the reporting date, the additional value of onerous contracts is included in the value of insurance contracts. Paragraph 103(b)(iv) requires the disclosure of a reconciliation for the changes in losses for onerous groups of contracts and the reversal of such losses over the accounting period.

15.26. How is the value for onerous contracts at initial recognition and changes in that value at subsequent measurement included in the statements for financial performance?

The illustrative examples include several examples considering the measurement of onerous contracts. Example 1 (IE4-IE17), specifically example 1B, shows initial measurement of an onerous contract. Example 2B (IE24-IE28) considers an example where changes in fulfilment cash flows create an onerous group of insurance contracts

and shows a possible format for reconciliation of the changes in value of the insurance contract (IE26-IE27) and shows the presentation in the statement of financial position and financial performance (IE28). Example 8 (IE81-IE98) shows possible formats for the reconciliation of the reversal of losses in an onerous group of insurance contracts.

15.27. How does presentation of financial position and financial performance differ for contracts measured using the PAA?

There are no changes to the presentation requirements for entities using the PAA. However, the amounts presented are based on the measurement amounts under the PAA (see chapter 7) and there are changes to the disclosure requirements explaining the presentation.

Under the PAA the contribution towards the value of insurance contracts from the liability for remaining coverage is the sum of the value of premiums allocated to the unexpired portion of insurance contracts recognised at the reporting date plus any additional liability for onerous contracts.

Insurance revenue under the PAA is the portion of expected premium receipts allocated in respect of coverage provided over the reporting period.

Insurance finance expense may exclude the unwind of the discount rate on the value of the unexpired coverage as entities using the PAA are not required to adjust for the time value of money and the effect for financial risk if, at initial recognition, the entity expects that the time between providing coverage and the related premium due date is no more than one year or the financial effect is not significant (paragraph 56).

Similarly, where the coverage period for each contract in a group of contracts is no more than one year, the entity may choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs (paragraph 59(a)). See also question 15.21 above.

Entities using the PAA are required to make additional disclosures as set out in paragraph 97.

Some of the requirements to disclose reconciliations (paragraphs 97-109) are amended or not applied when using the PAA.

15.28. How are contracts measured using the variable fee approach presented?

Adjustments to presentation under the variable fee approach are explained in chapter 7 on contracts with participating features and other variable cash flows.

Presentation for different types of entity

15.29. How does the presentation differ for mutual entities?

IAS 1 paragraph 6 explains that entities that do not have equity, such as some mutual funds, and entities whose share capital is not equity, such as some cooperative entities, may need to adapt the financial statement presentation of members' or policyholders' interests. Prior to implementation of IFRS 17, some entities presented a liability for

unallocated divisible surplus to represent the surplus which had not been allocated between participating policyholders prior to reporting the financial statements.

Under IFRS 17 estimates of the expected cash flows to participating policyholders are included in the value of insurance contracts. Unallocated divisible surplus will not be presented as a separate item and the amount is included in the fulfilment cash flows. Accounting mis-matches could give rise to equity in mutual entities (see BC266 and BC267).

BC269 notes that a mutual entity can distinguish:

(a) in the statement of financial position, the liability attributable to policyholders in their capacity as policyholders from the liability attributable to policyholders with the most residual interest in the entity; and

(b) in the statement(s) of financial position, the income or expenses attributable to policyholders in their capacity as policyholders before determination of the amounts attributable to policyholders with the most residual interest in the entity.

15.30. How does the presentation differ for entities with run off business?

In this IAN, run off business refers to where an entity has ceased to issue new policies for part or all of its business but is continuing to manage previously issued contracts. (This is sometimes also referred to with regard to life/annuity business as "closed books".) Provided that a business is a going concern, IFRS 17 presentation applies in the same way to reporting entities where some or all of the business is running off and to entities that continue to write new business.

IAS 1 requires that management of an entity reporting on an IFRS basis makes an assessment of the entity's ability to continue as a going concern. An insurer or reinsurer may continue to be a going concern for IFRS reporting purpose even if all the business is discontinued. Where a reporting entity is not considered to be a going concern, IAS 1 requires additional disclosures which may need to be taken into consideration when applying IFRS 17.

15.31. How does IFRS 17 presentation results differ for consolidated financial statements?

There are no differences in the requirements for presentation by a solo insurer or reinsurer and for a group that has issued insurance contracts within one of its group companies. However, as explained above, IFRS 17 needs to be applied with reference to the requirements of other relevant standards.

IFRS 10 *Consolidated Financial Statements*, sets out the requirements for producing consolidated financial statements. One of the requirements of IFRS 10 is that intra-group balances are eliminated on consolidation (see paragraph B86(b) of IFRS10). For example, where there are intra-group reinsurance arrangements, the consolidated amounts for insurance contracts and reinsurance contracts are not simply the sum of these amounts in the entity financial statements. Rather the amounts presented exclude the intra-group balances such that the value of reinsurance contracts for the consolidated group are only in relation to contracts entered into with parties outside the group. Consequently, it is

also necessary to be clear which entities in the group are consolidated for financial reporting purposes, as the consolidation requirements differ for wholly owned subsidiaries, different levels of participation in other businesses and joint ventures. Although these requirements are set out in IFRS 10, IFRS 17 and IAS 28, it is also important to understand how the reporting entity has implemented these requirements.

Where the consolidating group includes more than one insurer or reinsurer the valuation of groups of insurance contracts issued and reinsurance contracts held may be different in the results of the solo company compared to in the group results. One example of this is in relation to the calculation of the risk adjustment and the CSM. Paragraph B88 permits the allowance of diversification in the calculation of the risk adjustment at the reporting entity level. This is discussed further in chapter 4 on risk adjustment.

Further changes to the granularity of disclosures may be required, for example, in relation to segment reporting (see question 15.20 above), if the segments reported for the group and the solo entities within the group are not the same.

Interim reporting, disclosures and transition to IFRS 17

15.32. What is interim reporting and how does IFRS 17 apply to this?

An interim financial report is a financial report that contains either a complete or condensed set of financial statements for an interim period (i.e., a financial reporting period shorter than a full financial year). IAS 34 prescribes the minimum content of an interim financial report and the principles for recognition and measurement in financial statements presented for an interim period.

Paragraph B137 requires that *notwithstanding the requirements of IAS 34* Interim Financial Reporting *that the frequency of an entity's reporting shall not affect measurement of its annual results. An entity shall not change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim financial statements or in the annual reporting period*. This requirement may result in different entities with different interim reporting periods reporting different results for similar transactions.

15.33. Why can an entity change its IFRS 9 classification of financial instruments the first time it implements IFRS 17?

Paragraph C29 sets out the conditions for redesignation of financial assets under IFRS 9 if the entity applied IFRS 9 to annual reporting periods before the initial application of IFRS 17.

This may be important to reporting entities as the designation of financial instruments affects whether the performance of those financial instruments is reported in profit/loss or in OCI. Considering the presentation of financial instruments and insurance contracts together under IFRS 9 and IFRS 17 respectively, can help to minimise accounting mismatches by allowing movements due to the same underlying factors (e.g., movements in financial market values and market consistent assumptions) to be presented in the same statement i.e., in profit/loss or in OCI.

If a redesignation of financial assets under IFRS 9 is made upon initial application of IFRS 17, then the entity must:

- Apply the designations and classifications retrospectively, applying the relevant transition requirements in IFRS 9 (paragraph C30);
- Either restate prior periods to reflect changes to designations and classifications *or* if the entity does not restate prior periods then the entity must recognise the impact of the redesignation in opening retained earnings (or other component of equity) (paragraph C31); and
- Include certain disclosures pertaining to any redesignation of financial assets (paragraphs C32-C33).

Presentation of acquisition costs and other insurance expenses

15.34. When and where are acquisition costs included in the statements of financial position and financial performance?

When insurance contracts are recognised (see chapter 11), they are included in the statements of financial position and financial performance because the cash flows within the contract boundary may include an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs (B65(e)). This recognises that in order to sell insurance contracts where the sales force is not solely remunerated based on commission per contract sold, the entity will incur expenses attempting to sell some contracts that are ultimately not purchased.

If the acquisition expenses directly attributable to the portfolio were paid before initial recognition of the contract, that amount is included in the initial measurement of the portfolio of insurance contracts such that the CSM is reduced for the cost of the acquisition expenses (see chapter 8).

If acquisition costs have been incurred prior to the financial reporting date and are associated with insurance contracts which will not be recognised until a later date, there will be no group of insurance contracts to which those expenses can be allocated. In those circumstances, the reporting entity can include an asset or liability in the statement of financial position for the value of those acquisition costs. This asset or liability for acquisition costs is derecognised when the relevant insurance contracts are recognised so there is a group of insurance contracts to which the acquisition expenses can be allocated (paragraph 27). If the contract boundary is one year or less and the PAA is used, this treatment of acquisition costs is optional and the reporting entity can choose to recognise the acquisition costs as expense or income in the statement of financial performance when they are incurred (paragraphs 27, 38(b) and 59(a)).

Assets or liabilities for acquisition costs are not shown as a separate line item in the statement of financial position but are included in the carrying amount of the related groups of insurance contracts issued or reinsurance contracts held (paragraph 79).

There are a number of specific disclosure requirements for insurance acquisition costs. In relation to the reconciliations required in paragraph 100, these are covered in paragraph

103-107. If an entity uses the PAA, it also discloses the method it has chosen to recognise insurance acquisition cash flows applying paragraph 59(a).

15.35. When and where are claims handling expenses included in the statements of financial position and financial performance?

Under the GMA, claim handling costs (i.e., 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) are included in the insurance contract cash flows (paragraph B65(f)) and so are recognised in the financial statements when the associated insurance contracts are recognised, if those cash flows are within the contract boundary. Consequently, claims handling expenses are included in the valuation of insurance contracts and reinsurance contracts held in the statement of financial position; are included in insurance revenue in respect of services expected to be delivered in the financial reporting period; and are included in insurance service expense in the period in which the actual costs are incurred.

Under the PAA, claims handling costs are not explicitly included in the liability for remaining coverage and therefore are recognised when the claim is incurred.

15.36. When and where are indirect expenses and overheads included in the statements of financial position and financial performance?

Indirect expenses (i.e., expenses that are not directly attributable to a portfolio of insurance contracts) and overheads are included in the valuation of insurance contracts in the statement of financial position if they are related to the fulfilment of insurance contracts that are recognised in the financial statements and if the expense cash flows are within the contract boundary. See chapter 1 for insurance contract recognition and contract boundary.

Paragraph B65(l) sets out which types of insurance expenses may be included and restrictions on their inclusion. For example, overheads must be allocated to groups of contracts using methods that are systematic and rational. Paragraph B66(d) explicitly excludes costs that cannot be directly attributed to the portfolio (e.g., some product development and training costs). Which cash flows may be included is covered in more detail in chapter 2.

Indirect expenses and overheads that are included in the valuation of insurance contracts are recognised in the financial statements when the associated groups of insurance contracts are recognised provided those cash flows are within the contract boundary. Consequently, indirect expenses and allocated overheads are included in the valuation of insurance contracts and reinsurance contracts held in the statement of financial position; are, under the GMA, included in insurance revenue in respect of insurance services expected to be delivered in the financial reporting period; and are included in insurance service expense in the period in which the costs are incurred.

Expenses that cannot be included in the valuation of insurance contracts are recognised in the statement of financial performance in the period in which they are incurred, unless

they fall within another accounting standard which prescribed an alternative accounting treatment.

Section C - Disclosures

This section provides general comments on the disclosures required to explain the presentation such as the required reconciliations.

Overview of IFRS Disclosures

15.37. What is meant by "disclosures" in IFRS 17?

The objective of the disclosure requirements is for an entity to disclose information in the notes to the financial statements, enabling users of the financial statements to assess the effect of contracts within the scope of IFRS 17 on the entity's statement of financial position and statement(s) of financial performance and statement of cash flows. The disclosures cover information about the amounts recognised in the financial statements; significant judgment and changes in those judgments; and the nature and extent of risks from contracts in scope of IFRS 17. The disclosure requirements are set out in paragraphs 93 to 132.

15.38. What is the objective of the disclosure requirements and what might be the role of an actuary helping to produce IFRS 17 disclosures?

Paragraph 93 specifies that the objective of disclosure requirements is to give users of financial statements, together with information presented in the statement of financial position, statement of financial performance and statement of cash flows, a basis to assess the effect that contracts within the scope of IFRS 17 have on the entity's financial position, financial performance and cash flows.

Typically the finance or accounting team will have ultimate responsibility for the information contained in the financial statements, including the disclosures. The actuary's role in preparing disclosures is likely to be a supporting role to the individual or team responsible for preparing the overall financial statements. This may include:

- Preparing numerical information specific to the disclosures that is not recorded in core finance systems or which is sourced from actuarial models – for example estimates of claims development and sensitivities to insurance and market risks.
- Supporting the preparation of, or reviewing, qualitative information included in the disclosures – for example qualitative information on how the entity manages the various types of risk to which it is exposed.
- Review of other qualitative or quantitative information included in the financial statements to support the overall integrity of the disclosures and to ensure that the information included presents a fair and accurate representation of the effect of the contracts within the scope of IFRS 17 at the reporting date.

15.39. Do you need to show separate reconciliations for reinsurance contracts held?

Yes, paragraph 98 specifies that separate reconciliations shall be disclosed for insurance contracts issued and reinsurance contracts held and that the reconciliations should be adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued.

15.40. Are there any changes to the presentation or disclosure requirements when applying IFRS 17 for the first time?

Paragraphs C25 – C28 specifies exceptions to the presentation of comparative information when applying IFRS 17 for the first time. These are summarised below.

- Comparative information for periods earlier than the beginning of the annual reporting period immediately preceding the date of initial application may be included but is not required.
- Disclosures specified in paragraphs 93 – 132 are not required for comparative periods before the beginning of the annual reporting period immediately preceding the date of initial application.
- If unadjusted comparative information and disclosures are presented for earlier periods, it must be disclosed that the information has not been adjusted and explain the basis on which it has been prepared.
- Previously unpublished information about claims development that occurred earlier than five years prior to transition to IFRS 17 need not be disclosed. However, if an entity does not disclose that information, it shall disclose that fact.

If an entity redesignates financial assets under IFRS 9 in accordance with paragraph C29 then additional disclosures must be made in accordance with paragraphs C32 and C33.

Appendix – How does presentation and disclosures differ in IFRS 17 compared with the previous standard for insurance contracts IFRS 4?

The answer here is intended to give an overview of the key differences. The details of the changes in IFRS 17 are considered in more detail in other questions in this chapter.

Under IFRS 4, presentation of insurance contracts in the financial statements in each jurisdiction could vary as IFRS 4 permitted the grandfathering of previous accounting policies based on the local GAAP basis applying before IFRS 4 was implemented. Entities reporting under IFRS 4 also had to apply the principles set out in IAS 1. The presentation of insurance contracts in the statement of financial position under IFRS 17 might be broadly similar to the typical way in which the balance sheet is presented under IFRS 4. However, the values presented may be significantly different. This difference arises because the measurement basis for contracts within the scope of IFRS 17 is based on expected future cash flows rather than the deferral and matching approach used by many insurers reporting under IFRS 4. One of the impacts of this change is that some amounts previously included under amounts payable and amount receivable, such as balances with brokers and reinsurers, may now be included in the valuation of insurance contracts and reinsurance contracts held. Further, these valuations may also be adjusted for future cash flows to be received or to be paid, not currently included in the valuation of insurance contracts and ceded reinsurance under IFRS 4.

The cash flow basis in IFRS 17 may result in a significant change to the value of individual items presented in the statement of financial position. Impacts include changes to the measurement basis between IFRS 4 and IFRS 17, notably the introduction of, or changes to, the discounting basis (see chapter 3), the basis for setting the risk margin (see chapter 4), and the introduction of the CSM (see chapter 6).

Under IFRS 17, it will be necessary to present and disclose separately the investment component of insurance contracts that are excluded from revenue and expenses. Paragraphs 84-85, being read with reference to paragraph 13, requires that insurance revenue and insurance service expenses exclude receipt and payment of investment components. Paragraphs 103(c) and 117(c)(iv) requires separate disclosures for investment components excluded from insurance revenue and insurance service expenses.

The presentation of financial performance for insurance contracts is likely to be significantly different under IFRS 17 compared with IFRS 4. IFRS 17 introduces a new definition of revenue, which does not necessarily reconcile to actual premium income over the reporting period. IFRS 17 also sets out a new basis for calculating profit or loss. The presentation of financial performance separates the profit and loss arising from the insurance service from insurance finance income and expense, which includes the effect of allowing for time value of money. The extent of the changes to the presentation of financial performance may make it relatively difficult to make comparisons between the income and expenses presented under IFRS 17 with equivalent amounts presented on an IFRS 4 basis except where the PAA is used under IFRS 17. For contracts where PAA is used, the presentation is likely to have greater similarity to the presentation under IFRS 4. This will particularly be the case if the IFRS 4 reporting basis was based on earned premiums and claims reserves i.e., as is/was common for many non-life contracts under IFRS4.

The objectives of the disclosure requirements in IFRS 17 are broadly similar to those in IFRS 4. However, because the measurement basis in IFRS 17 is significantly different to the measurement basis used by insurers reporting under IFRS 4, there are requirements for many new reconciliations to explain the amounts presented in the financial statements (see paragraphs 97-117). To meet the overarching objective for disclosures under IFRS 17, risk metrics used in the disclosure on the nature and extent of risks (paragraphs 121-132) need to be consistent with the IFRS 17 measurement basis.