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Draft Educational Note

IFRS 17 Measurement and Presentation of Canadian Participating Insurance Contracts

Document 221039

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Committee on Life Insurance Financial Reporting

April 2021

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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. As standards of practice evolve, an educational note may not reference the most current version of the standards of practice; and as such, the actuary should cross-reference with current standards. To assist the actuary, the CIA website contains an up-to-date reference document of impending changes to update educational notes.

MEMORANDUM

To: Members in the life insurance area

From: Steven W. Easson, Chair
Actuarial Guidance Council

Marie-Andrée Boucher, Co-Chair
Steve Bocking, Co-Chair
Committee on Life Insurance Financial Reporting

Date: April 27, 2021

Subject: **Draft Educational Note: IFRS 17 Measurement and Presentation of Canadian Participating Insurance Contracts**

The Committee on Life Insurance Financial Reporting (CLIFR) has prepared this draft educational note to provide guidance related to the measurement and presentation of Canadian participating insurance contracts under International Financial Reporting Standard (IFRS) 17.

It is written from the perspective of Canadian actuaries and is not intended to duplicate any other guidance. Additional information can be found in IAA guidance or other CIA documents. The draft educational note *Compliance with IFRS 17 Applicable Guidance* provides guidance to actuaries when assessing compliance with IFRS 17. It is applicable to all educational notes pertaining to IFRS 17 and members are encouraged to review it prior to reading any educational note related to IFRS 17.

A preliminary version of this draft educational note was shared with the following committees:

- Property & Casualty Insurance Financial Reporting Committee
- Committee on Risk Management and Capital Requirements
- Committee on the Appointed/Valuation Actuary
- International Insurance Accounting Committee
- Workers' Compensation Committee

A preliminary version of the draft educational note was also shared with the staff of the Accounting Standards Board (AcSB) to broaden consultations with the accounting community. Given that this draft educational note provides actuarial guidance rather than accounting guidance, the AcSB staff review was limited to citations of and any inconsistencies with IFRS 17. CIA educational notes do not go through the AcSB's due process and therefore, are not endorsed by the AcSB.

This draft educational note was also presented several times at the Actuarial Guidance Council (AGC) in the months preceding this request for approval. CLIFR is satisfied it has sufficiently addressed the comments received. For the final version of this educational note, CLIFR will consider incorporating additional guidance, notably extra guidance measuring the cost of guarantee.

The creation of this cover letter and draft educational note has followed the AGC protocol for the adoption of educational notes. In accordance with the CIA's *Policy on Due Process for the Approval of Guidance Material other than Standards of Practice and Research Documents*, this draft educational note has been prepared by CLIFR and has received approval for distribution from the AGC on April 6, 2021.

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. As standards of practice evolve, an educational note may not reference the most current version of the standards of practice; and as such, the actuary should cross-reference with current standards. To assist the actuary, the CIA website contains an up-to-date reference document of impending changes to update educational notes.

CLIFR would like to acknowledge the contribution of its subcommittee that assisted in the development of this draft educational note: Steve Bocking (Chair), Nathalie Cloutier, Trudy Engel, Frédéric Tremblay, Lisa Gi[illegible]ncola, Sylvain Lefebvre, Joe Smadella, Lesley Thomson, and Emily Zhang.

Questions or comments regarding this draft educational note are invited **by July 31, 2021** and may be directed to Marie-Andrée Boucher at mboucher@eckler.ca, and Steve Bocking at steve.bocking@canadalife.com.

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1. Introduction

IFRS 17 establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts.

The purpose of this draft educational note is to provide practical application guidance on Canadian-specific issues relating to measurement and presentation of Canadian participating insurance contracts under IFRS 17. This guidance would apply to entities that issue Canadian participating insurance contracts.

The guiding principles that the CLIFR Subcommittee followed in writing this draft educational note were the following:

- First and foremost, consider Canadian-specific perspectives, rather than simply repeating international actuarial guidance.
- Provide application guidance that is consistent with IFRS 17 and applicable Canadian actuarial standards of practice and educational notes, without unnecessarily narrowing the policy choices available in IFRS 17.
- Consider practical implications associated with implementation of potential methods; in particular, ensure that due consideration is given to options that do not require undue cost and effort to implement.

The draft educational note *Application of IFRS 17 Insurance Contracts* provides general guidance on topics relevant to participating insurance contracts. Published in February 2019, that note is an adoption without modification of the January 2019 exposure draft of International Actuarial Note (IAN) 100. A first version of the IAN 100 is expected to be published in 2021, which will consider the comments made by the different bodies in addition to providing additional guidance related to the June 2020 amendments to IFRS 17.

2. Background

Participating insurance contracts in Canada are offered by mutual insurance companies, stock/shareholder companies, and fraternal benefit societies. The fundamentals of measurement are the same regardless of company structure; however, the company structure can affect the measurement model and presentation in the statement of financial position.

2.1 Stock/shareholder and mutual companies

2.1.1 Separate participating accounts

For federally regulated insurance companies, the Insurance Companies Act (Canada) (ICA) Section 456 requires companies to maintain accounts in respect of participating insurance policies (called "participating accounts") separately from those maintained in respect of other policies. ICA Sections 457–464 cover requirements for the fair and equitable allocation of investment income, expenses, and taxes to the participating accounts and limitations on amounts that can be transferred out of the participating accounts to shareholder accounts in stock/shareholder companies and to non-participating accounts in mutual companies.

Net income (profit/loss) and equity (surplus) of the participating accounts is reported separately from the other accounts in the financial statements. IFRS 17 has no effect on any ICA requirements, so this separate reporting will still be required. For example, any contractual

service margin (CSM) associated with policies in the participating account will be reported in the participating account, and the amortization of that CSM will be part of participating account income and flow into participating account surplus.

Note that the amounts reported as participating account surplus and considered contribution to surplus might change under IFRS 17. For example, a portion of surplus might become CSM (see Section 6.4). Also, for contracts where experience is shared (so IFRS 17.B67 applies), IFRS 17.B68 requires consideration of whether there are obligations to **future** policy-holders, and if so, such amounts would be included in the present value of future cash flows rather than surplus under IFRS 17. Consideration of whether there are obligations to future policy-holders would take into account all legal and constructive obligations.

For companies registered/regulated in Québec, Sections 539-549 of the Québec Insurer's Act (QIA) cover requirements for participating insurance policies. The QIA goes into less detail than the ICA, however, treatment of participating policy-holders is overseen by the Autorité des marchés financiers (AMF) under its Sound Commercial Practices Guideline. The AMF is highly involved to ensure consumers are treated fairly and requires companies to have internal policies to govern their participating accounts including how experience is returned to policy-holders. This leads to a regulatory environment in Québec that is similar to that for federally regulated insurance companies; however, there may be unique circumstances that need to be considered.

Since it is applicable in all countries (regardless of the regulatory environment), IFRS 17 does not deal with the participating account separately. That is, "the entity" in IFRS 17 refers to the entire company (including the participating accounts), and terms such as "equity" and "profit and loss" and "liabilities" include amounts that (in Canada) would be reported both in the participating accounts and the other accounts.

2.1.2 Demutualization

In 1999 and 2000, four of Canada's largest federally regulated companies converted from mutual companies to stock companies. At demutualization, participating policy-holders were compensated for their ownership rights, which were relinquished. Their contractual rights were protected through the establishment of "closed blocks," which are promised to be returned over time in full to the policy-holders in the closed blocks. Any participating policies sold after demutualization are accounted for separately, in "open blocks" or "post-demutualization blocks."

At the time of demutualization, Section 462 of the ICA was amended to allow for transfers from the participating accounts for amounts in respect of demutualization. Such amounts are accounted for separately in "ancillary blocks" or "transfer blocks," which contain amounts related to pre-demutualization policies that are outside the closed blocks, such as provisions for adverse deviations (PfADs) on pre-demutualization policies and sometimes (depending on the company's demutualization plan) amounts on deposit or supplementary benefits and riders for pre-demutualization policies. Income arising from the ancillary blocks[1] may be transferred from the participating account to the shareholder account each quarter and reported with

[1] This applies to ancillary blocks held within the participating account. There are some ancillary blocks that are held outside the participating account, in which case the income is already within the shareholder account.

shareholder income and shareholder equity rather than participating policy-holder income and participating policy-holder equity.

In 2000, the largest Québec regulated insurance company also converted from a mutual company to a stock company. The law did not provide a framework for demutualization, so the demutualization was completed according to a private bill, however, the terms of demutualization were similar to those for the federally regulated companies.

2.1.3 Foreign subsidiaries of Canadian insurance companies

Participating insurance contracts in foreign subsidiaries of Canadian insurance companies are subject to local laws and regulations, which are similar to those in Canada for some jurisdictions (e.g., UK, Hong Kong), but not all. Companies might follow similar practices as they would for contracts subject to ICA regulations because they represent sound business and professional practice.

2.2 Fraternal benefit societies

The sections of the ICA that regulate participating insurance contracts described above do not apply to fraternal benefit societies.[2]

Part I subsection 13(2) of the ICA details the sections that apply to fraternal benefit societies. Sections 165 and 456–462 are not included in 13(2), and therefore fraternal benefit societies are not subject to those sections. Fraternal benefit societies might follow similar practices as if these ICA sections apply because they represent sound business and professional practice.

IFRS 17 has no effect on any Canadian regulatory requirements, so the requirements for fraternal benefit societies under the ICA are unchanged by IFRS 17.

3. Measurement model

This section considers whether Canadian participating insurance contracts meet the definition of an "insurance contract with direct participation features" under IFRS 17. The determination of whether a contract meets this definition is technically a contract-by-contract assessment. However, due to the sharing of experience among contracts with similar characteristics, the assessment would be completed at the level that experience is shared. This would typically be the "dividend class" level (see Section 4.2.1).

The discussion on the criterion in this section are viewed at the par account level; however, the criterion could also be reviewed at a lower level using the same concepts. The contracts(s) within the par account that may not meet the criterion could be removed and the remaining contract(s) could still be measured against the criterion. Also, if the contract(s) fail one of the criteria, then the remaining criterion do not need to be considered.

The applicable legal and regulatory framework affects the contractual terms of contracts (IFRS 17.2), so considerations are different for entities subject to different laws and regulations. This section considers participating insurance contracts in Canadian entities subject to federal or

[2] The sections of the ICA that regulate participating insurance contracts also do not apply to provincially incorporated insurance companies, foreign subsidiaries of a Canadian insurance company or to the Canadian branch of a foreign insurance company.

Québec regulation. IFRS 17.2 also notes that "contracts can be written, oral, or implied by an entity's customary business practices", and that "contractual terms include all terms in a contract, explicit or implied." This means that the contract is also influenced by a company's policies and practices, so these would have to be considered in the assessment of each criterion.

Insurance contracts that meet the definition of "insurance contract with direct participation features" are measured using the variable fee approach (VFA) rather than the general measurement approach (GMA). There is no difference between the VFA and the GMA at initial recognition, and no difference in the measurement of fulfilment cash flows (FCF) at any time; however, the measurement of the CSM after initial recognition is different – following IFRS 17.44 for the GMA and IFRS 17.45 for the VFA.

The definition of "insurance contract with direct participation features" appears in Appendix A of IFRS 17 as follows:

> *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**.*

IFRS 17.B101–B109 provide application guidance for assessing whether an insurance contract meets this definition. IFRS 17.BC238–BC249D provide important background for understanding the International Accounting Standards Board® (the Board)'s rationale in identifying those contracts for which the VFA was developed.

Sections 3.1–3.4 discuss the date of assessment and each of the three criteria of the definition of insurance contracts with direct participation features as they relate to Canadian participating insurance contracts. In summary, Canadian participating contracts issued by insurers would meet the definition of insurance contracts with direct participation features if, at the assessment date:

- The Dividend Policy indicates that policy-holders share in the experience of the participating account (see Section 3.2).
- The policy-holders' share includes a share of investment returns (see Section 3.3).
- The contribution to surplus is small enough to leave a "substantial" share to be paid to policy-holders (see Section 3.4).
- The minimum guarantees are low enough (or the dividend room is high enough) that the variable (shared) portion of amounts paid to policy-holders is substantial (see Section 3.5).

Fraternal benefit societies would assess each criterion based on the characteristics of their dividend-paying contracts, including the application of any legislative or regulatory rules and guidance, applying similar principles as those discussed below. As noted earlier, contracts

include an *entity's customary business practices* which would include its policies and practices. These would have to be considered in the assessment of each criterion.

Participating insurance contracts in foreign subsidiaries of Canadian insurance companies would be assessed in the context of the local legal and regulatory framework, applying similar principles as those discussed below.

3.1 Date of assessment

IFRS 17.B102 states that the criteria in the definition of insurance contracts with direct participating features are assessed using the entity's expectations at inception of the contract and would only be reassessed if the contract is modified (per IFRS 17.72). In Canada, demutualization would be considered a contract modification, as the terms of the contract were changed with agreement of policy-holders.

At transition to IFRS 17, if IFRS 17 is applied retrospectively (which it must be unless impracticable), the date of assessment would be the date of the most recent modification (or inception in the absence of modification). If retrospective application of IFRS 17 is impracticable, the entity chooses between the modified retrospective approach and the fair value approach.

If the modified retrospective approach is applied, the date of assessment (IFRS 17.C9(b)) would be:

- the date of the most recent modification (or inception in the absence of modification) for all contracts for which the entity has reasonable and supportable information to so assess; and
- the transition date for contracts for which the entity does not have such reasonable and supportable information.

If the fair value approach is applied, the entity has a choice (IFRS 17.C21–C22) between:

- the date of the most recent modification (or inception in the absence of modification) for any contracts for which the entity has reasonable and supportable information to so assess; and
- the transition date.

According to IFRS 17.C2, the transition date is "the beginning of the annual reporting period immediately preceding the date of initial application," which (for an effective date of January 1, 2023) would be January 1, 2022 for an entity with a fiscal year-end of December 31 and November 1, 2022 for an entity with a fiscal year-end of October 31.

Participating insurance contracts share experience among contracts with similar characteristics (see Section 4.2.1), commonly referred to as a "dividend class." Therefore, the same transition approach (retrospective, modified retrospective, or fair value) will apply to all contracts in a dividend class, and the same date of assessment will apply to all contracts in a dividend class.

3.2 The assessment of criterion (a)

Criterion (a) of the definition of "insurance contract with direct participation features" states that "the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items." This criterion is repeated in IFRS 17.B101(a) with the addition of "*(*see paragraphs B105–B106*).*"

3.2.1 Is there a "clearly identified pool of underlying items"?

Contracts that do not have a "clearly identified pool of underlying items" will be measured under the GMA and can be ignored for the rest of Section 3.

3.2.1.1 ICA/QIA

Section 456 of the ICA requires participating accounts to be maintained separately from other accounts. Segregation of assets is not required, but the method of allocating investment income to the participating account must be specified and approved (Section 457 of the ICA). More generally, the management of participating accounts in Canada is heavily regulated and the financial results are separately reported; therefore, a participating account forms a "clearly identified pool."

Furthermore, participating policies are eligible to share in the earnings of the participating account, as governed by Sections 165(2) and 464 of the ICA. Therefore, a participating account could comprise "underlying items" if the Dividend Policy established under Section 165(2) of the ICA is such that the policy-holder shares in the experience of the participating account. There are participating insurance contracts in Canada that do not share experience (e.g., dividends are nil or fixed), or where dividends are based on something other than experience of the participating account. This means that the participating account would not meet the definition of an "underlying item." The contracts would not meet the definition of "insurance contracts with direct participation features," consistent with IFRS 17.B106(b), unless another underlying item is identifiable.

However, typical Canadian participating insurance contracts do share in the experience of the participating account, and therefore have a "clearly identified pool of underlying items."

For entities subject to the QIA, sections 542–549 provide the analogous framework for identifying a "clearly identified pool of underlying items."

The restrictions within the ICA/QIA would also restrict the retrospective restatement of the participating accounts.

3.2.1.2 Other entities

As noted in section 2.2 above, fraternal benefit societies are not subject to Sections 165 and 456–462 of the ICA; therefore, whether or not there is a "clearly identified pool of underlying items" for dividend-paying contracts would be assessed based on the features of those contracts in the context of IFRS 17.2 (i.e., considering all substantive rights and obligations).

The same is true for participating insurance contracts in foreign subsidiaries of Canadian insurance companies. In some countries, laws, and regulations are similar to those in Canada and require a separate fund be held for the benefit of participating insurance policy-holders with limited (usually 10%) shareholder profit. Such funds (called "90/10 funds" in this draft educational note) would usually be considered a "clearly identified pool of underlying items."

Note that substantive rights and obligations include any agreements made at demutualization or merger/acquisition. For example, it is common to set up a ring-fenced (closed) block to protect the interests of participating policy-holders on acquisition of a company with participating insurance contracts. Such a ring-fenced block would often qualify as a "clearly identified pool of underlying items."

3.2.2 Substantially investment related service contracts

The introduction to IFRS 17.B101 says "Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items." Though this sentence is not part of the definition itself, it might suggest that the definition is limited to contracts that share only investment returns.

Canadian participating insurance contracts typically include sharing of mortality gains/losses and other experience items in addition to investment returns. However, IFRS 17.B106 and IFRS 17.BC245 (as well as the definition of "underlying items"[3] in Appendix A of IFRS 17) confirm that the pool of underlying items can comprise any items and need not be limited to financial assets with the policy-holder share being a share of investment returns. Therefore, the fact that the policy-holder share of the participating account includes elements related to mortality and other experience and not solely investment return does not preclude a participating account from being a "clearly identified pool of underlying items" under IFRS 17.B101(a). It doesn't guarantee it either of course; a participating account established with little or no sharing of investment returns might be judged not to meet the criterion of paragraph IFRS 17.B101(a) because of the introduction to IFRS 17.B101.

Typical Canadian participating insurance contracts include sharing of investment returns in addition to mortality and other experience items, and if so are not precluded from meeting the definition of insurance contracts with direct participation features because of the introduction to IFRS 17.B101. This view is consistent with that adopted by actuaries in other countries with similar contracts (e.g., UK, Belgium, Germany and Australia).

3.2.3 Contractual terms specify that the policyholder participates in a share

In Canada, the contract itself would rarely specify the terms under which the policy-holder shares in the results of the participating account, and dividends are declared at the discretion of the Board of Directors. However, IFRS 17.B105 clarifies that the existence of such discretion does not imply that IFRS 17.B101(a) is not met, provided the link to underlying items is **enforceable**, with reference to IFRS 17.2.

IFRS 17.2 says that enforceability of the rights and obligations in a contract is a matter of law, and that contracts can be written, oral, or implied by an entity's customary business practices. Further, IFRS 17.2 clarifies that "contractual terms" include implied terms in a contract, which include those imposed by law or regulation.

As noted above, for Canadian insurers, the link to underlying items is made through the ICA/QIA (law) and supporting regulations and is further supplemented by Office of the Superintendent of Financial Institutions (OSFI)/AMF guidelines and CIA *Standards of Practice* and other guidance. This framework of laws, regulations and professional guidance protects the interests of participating policy-holders and establishes enforceability of the link to underlying items.

In particular, for the ICA:

[3] Appendix A of IFRS 17 defines underlying items as: *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*."

- Dividend policy – A dividend policy in which the link is described must be established (ICA 165(2e)[4]), fair to policy-holders in the opinion of the Appointed Actuary (ICA 165(3.1)), and publicly disclosed (ICA 165(4.1)[5]).
- Dividends paid – Dividends are paid in accordance with the dividend policy (ICA 464(1), and are fair to policy-holders in the opinion of the Appointed Actuary (ICA 464(2)).
- Participating account management policy – A participating account management policy must be established (ICA 165(2e.1)[6]), fair to policy-holders in the opinion of the Appointed Actuary (ICA 165(3.2)), and publicly disclosed (ICA 165(4.1)[7]). Together with the Dividend Policy, the Participating Account Management Policy provides the information necessary for policy-holders to understand the operations of participating accounts and to enable them to form reasonable expectations with respect to future dividends.
- Allocations – Allocations of investment income, expenses and taxes to the participating accounts are fair and equitable to participating policyholders in the opinion of the Appointed Actuary (ICA 456–460).
- Transfers – Amounts transferred out of the participating accounts are strictly limited (ICA 461–462).
- Assessing fairness – Both OSFI (Guideline E–15 *Participating Account Management and Disclosure to Participating Policyholders and Adjustable Policyholders*) and the CIA (educational note 211123 *Guidance on Fairness Opinions Required under the Insurance Companies Act Pursuant to Bill C-31*) provide guidance on assessing fairness.
- Closed blocks – For closed blocks established at demutualization, additional operating rules clarify the nature of the link (as pre-established at demutualization) and provide an additional dimension to the enforceability.

Note that the assessment date could be relevant here because the details of the legal and regulatory framework have evolved over time. However, the core ICA requirements related to maintaining a separate participating account and dividend practices have been in place for decades.

For fraternal benefit societies and foreign subsidiaries of Canadian insurance companies, the enforceability of the link to underlying items would be assessed in the context of IFRS 17.2.

3.3 The assessment of criterion (b)

Criterion (b) of the definition of "insurance contract with direct participation features" states that "the entity expects to pay to the policyholder an amount equal to a substantial share of the

[4] Supplemented by Policyholder Disclosure Regulations, Part 1, subsection 2, which describes required content of the Dividend Policy.
[5] Supplemented by Policyholder Disclosure Regulations, Part 1, subsection 4, which describes disclosure requirements for the Dividend Policy.
[6] Supplemented by Policyholder Disclosure Regulations, Part 1, subsection 3, which describes required content of the Participating Account Management Policy.
[7] Supplemented by Policyholder Disclosure Regulations, Part 1, subsection 4, which describes disclosure requirements for the Participating Account Management Policy.

fair value returns on the underlying items." This criterion is repeated in IFRS 17.B101(b) with the addition of "(see paragraph B107)".

According to IFRS 17.B104, "the entity's obligation to the policyholder is the net of:

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

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

   i. the entity's share of the fair value of the underlying items, less

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

Criterion (b) refers to sharing of fair value returns. In Canadian participating insurance contracts, sharing of investment returns is commonly measured on a basis other than fair value to provide smoother period-to-period dividends to policy-holders. However, paragraph B107(b)(i) clarifies that the assessment of variability should be considered over the duration of contracts; therefore, provided that the entire fair value is shared over time, criterion (b) could still be met even if period-to-period fair value returns are smoothed[8]. B107(b)(ii) further notes that the variability should be assessed "on a present value probability-weighted average basis, not a best or worst outcome basis (see paragraphs B37–B38)."

Criterion (b) also requires the variable fee to be small enough so the remaining amount of the return paid to policyholders is "substantial." The word "substantial" is not defined, though IFRS 17.B107 provides some considerations for the entity. IFRS 17.B107(a) notes that "an entity shall:

> *(a)* interpret the term 'substantial' in both paragraphs in the context of the objective of insurance contracts with direct participation features being contracts under which the entity provides investment-related services and is compensated for the services by a fee that is determined by reference to the underlying items;"

The variable fee needs to be identified. The following sections discuss the identification of the variable fee for different types of par account structures.

3.3.1 Variable fee for closed blocks (demutualization)

For closed blocks set up at demutualization, the entire closed block will be paid to policy-holders. The contribution to surplus from these contracts (which would be IFRS 17.B104(b)(i)) is nil, because it was removed from the participating account at demutualization. Amounts that are the responsibility of shareholders (which would be IFRS 17.B104(b)(ii)), such as the cost of guarantees and items not shared with policy-holders, are held in the ancillary block. Depending on the structure of the demutualization, the ancillary block could be inside or outside the participating account.

If the ancillary block is outside the participating account, criterion (b) is clearly met because all fair value returns on the underlying items are paid to policy-holders over the duration of the contracts.

[8] See also IASB Transition Resource Group (TRG) – Feb 2018 AP07, log #S26.

If the ancillary block is inside the participating account, criterion (b) would be met as long as the size of the closed block is a substantial share of the total of the closed and ancillary blocks, which would typically be the case. If not, an alternative would be to consider the closed block itself (i.e., excluding the ancillary block) to be the **underlying items** for these contracts, in which case criterion (b) is clearly met because all fair value returns of the closed block are paid to policy-holders over the duration of the contracts. This is analogous to the case where the ancillary block is held outside the participating account.

3.3.2 Variable fee for other blocks

For other blocks, in addition to the amounts that are the responsibility of shareholders (IFRS 17.B104(b)(ii)), such as the cost of guarantees and items not shared with policyholders, the variable fee will usually include contributions to surplus (IFRS 17.B104(b)(i)). These contributions to surplus are often expressed as a small deduction from investment returns shared with policyholders, though they can also be reflected in a different manner (e.g., per $1000 deduction from the mortality component; % of premium).

For these blocks, criterion (b) will be met provided the contribution to surplus leaves a substantial share to be paid to policy-holders, which would typically be the case for Canadian participating insurance contracts. For example, if the expected return on underlying item is 5% and the contribution to surplus deduction was 0.25%, then 4.75% (or 95%) of the return on the underlying item is expected to be paid back to policyholders. The variable fee would be 5% and criterion (b) would be met.

There is one other consideration for these blocks if the date of assessment is the transition date (see Section 3.1). In Canada, some contributions to surplus are accumulated in the participating account. If considered part of the underlying items and fair value returns are not promised to be paid to policy-holders, it is possible that the policy-holders' share of the underlying is too small to be considered "substantial." However, if the date of assessment is inception, accumulated surplus is nil and would have no impact on the assessment of criterion (b).

3.3.3 Variable fee for blocks in foreign subsidiaries

The variable fee will depend on the structure of the participating products, which will be subject to local laws and regulations.

For underlying items that are "90/10 funds" (see Section 3.2.1.1), where 90% of experience is shared with policy-holders, the variable fee is 10% and criterion (b) would be met.

3.4 The assessment of criterion (c)

Criterion (c) of the definition of "insurance contract with direct participation features" states that "the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items." This criterion is repeated in IFRS 17.B101(c) with the addition of "(see paragraph B107)."

IFRS 17.B108, which expands on IFRS 17.B107, clarifies that the purpose of criterion (c) is to exclude contracts with high minimum guarantees; i.e., where the shared portion of amounts paid to policy-holders is relatively low. IFRS 17.B108 further clarifies that this should be assessed based on a present value probability-weighted average of all scenarios (also noted in IFRS

17.B107(b)(ii)). These scenarios would be consistent with the entity's expectations. The amount of dividend room will be negatively correlated with the cost of guarantee.

In other words, criterion (c) would be assessed by considering the amount of dividend room available to absorb adverse experience. Contracts with high minimum guarantees might not meet this criterion as they would likely have a high cost of guarantee (i.e., non-varying amount) and low expected future dividends (i.e., varying amount), though such contracts might already have been eliminated based on criterion (a) because the sharing of experience is limited (see Section 3.2). For example, a "90/10 fund" with high guaranteed returns would pass criterion (a) and (b) but would fail criterion (c).

Note that the assessment date is relevant here (see Section 3.1). Insurance contracts with plenty of dividend room at inception (or the most recent modification) might have little or no dividend room left at the transition date if historical experience has been unfavourable.

4. Unit of account/level of aggregation

4.1 Portfolios

According to IFRS 17.14, portfolios comprise contracts subject to **similar risks and managed together**. For Canadian participating insurance contracts, identification of portfolios will usually be straightforward, as contracts that are **managed together** will share underlying items.

Under IFRS 17, the facts and circumstances under which contracts can be separated (and potentially assigned to different portfolios or groups) are limited.[9] For example, for closed blocks established at demutualization, each contract includes its components in the closed block (the items shared with other policy-holders) and its components in the ancillary block (the items not shared with the other policy-holders).

However, if there are components of participating insurance contracts held outside the participating account, it might be necessary to treat those components as if they were separate contracts (in a portfolio outside the participating account) to allow compliance with the ICA/QIA or demutualization agreement requirements to maintain participating accounts separate from other accounts. If the components are not treated as separate contracts, a clear and fair allocation of the total contract liability between the participating account and the shareholder/non-participating account would be needed.

4.2 Groups

Per IFRS 17.16–17, contracts in a portfolio are divided into a minimum of three profitability groups (onerous,[10] no significant possibility of becoming onerous, and other) at initial recognition, though one or two of those groups could be empty if all contracts have a similar level of profitability at issue. Further, IFRS 17.22 states that an entity shall not include contracts issued more than one year apart in the same group (called "annual cohort"), though this requirement is waived for portfolios using the fair value approach at transition (IFRS 17.C23).

Once contracts are placed into groups (at transition or at initial recognition thereafter), grouping is not reassessed (see IFRS 17.24); i.e., contracts are not moved among groups.

[9] See IASB Transition Resource Group (TRG) – Feb 2018 AP01 and May 2018 AP01.
[10] "Onerous" means there is no CSM.

For Canadian participating insurance contracts, the IFRS 17 requirements for grouping of new contracts after transition are complicated if experience on contracts issued pre-transition is shared with experience on contracts issued post-transition. This is covered by IFRS 17.B67–B71, which states that cash flows from one group should be adjusted for cash flows in another group to the extent they are affected by cash flows to/from policyholders in the other group. In addition, IFRS 17.B70 states that "in some cases, an entity might be able to identify the change in the underlying items and resulting change in the cash flows only at a higher level of aggregation than groups. In such cases, the entity shall allocate the effect of the change to each group on a systematic and rational basis."

Additionally, IFRS 17.BC138 acknowledges that annual *cohorts "*create an artificial divide for contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group*,"* and that, "for contracts that fully share risks, the groups together will give the same results as a single combined risk-sharing portfolio*."* The Board "concluded that setting the boundary for such an exception would add complexity to IFRS 17 and create the risk that the boundary would not be robust or appropriate in all circumstances. Hence IFRS 17 does not include such an exception. Nonetheless, the Board noted that the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts. Therefore it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances."

The remainder of this section discusses the circumstances under which establishing groups at a higher level might be equivalent to grouping by annual cohort.

4.2.1 "Dividend class"

Canadian participating insurance contracts are contracts where policy-holders share in the experience of the participating account (underlying item). In practice, experience is shared within sets of contracts with similar features – called "dividend class" in this paper, but sometimes called "dividend cohort" – which typically include contracts issued over a number of calendar years.

Under certain conditions, the profitability of all contracts within a dividend class is the same. These conditions are the following:

- Full sharing of risk experience within the dividend class (sometimes called "mutualization"), so that if some contracts in the class run out of dividend room, dividends of other contracts in the class can be reduced to cover the shortfall. Only if dividends are depleted for all contracts in the class would there be a loss, and this loss may be recoverable in future periods (before dividend payments are resumed) if the dividend class later produces a gain.
- Depletion of dividend room in a dividend class cannot normally be covered by reducing dividends in a different dividend class. OSFI Guideline E-16 includes requirements for the fair treatment of participating policyholders in Canada and is supplemented by CIA guidance.[11] To ensure fairness, dividend classes may also be chosen to differentiate contracts with significant differences (e.g., different product designs).

[11] CIA Educational Note Guidance on Fairness Opinions Required Under the Insurance Companies Act Pursuant to Bill C-57 (2005), Document 211123.

- The contribution to surplus is often similar for all contracts within a dividend class, which leads to a similar level of profitability. If a change in the contribution to surplus materially changes the expected profitability, a new dividend class might be established.

Under the above conditions, the profitability of all contracts within a dividend class is the same by design. Any allocation or attribution of costs among contracts issued in different years would preserve this similarity of profitability, so that the profitability of annual cohort would be the same as the profitability of the entire dividend class. If annual cohorts are used, the allocation of amounts to annual cohorts within a dividend class would get back to the same place as if dividend class were the level of aggregation.

However, the pattern of the CSM amortization may be different when measuring at a dividend class versus annual cohort level. The following are some items that could impact the difference in the CSM amortization when measuring at a dividend class level rather than an annual cohort level: how many calendar years are included in a dividend class, the homogeneity of these calendar years, the choice of coverage units, etc. For example, a dividend class that includes many calendar years may produce a more material difference than a dividend class that only includes a few calendar years.

4.2.2 Annual cohorts

The Board discussed the issue of annual cohorts on contracts with mutualization many times, including September 2018 (TRG), March 2019 (AP2B–2c), June 2019 (Amendments BC173–BC179), February 2020 (AP2B), and June 2020 (Amendments BC139I–BC139S).

Although the Board decided not to create an exception to the annual cohort requirement, it recognized that there are certain features of a contract that might result in the costs of the annual cohort requirement outweighing the benefits of the resulting information. These features are the following:

- Paragraphs B67–B72 apply (i.e., mutualization).
- The entity has discretion in how returns on the underlying items are shared with and among policy-holders.
- Amounts for items not shared with policy-holders (including the cost of guarantees) are small.
- The contracts meet criterion (a) of the definition of insurance contracts with direct participation features (i.e., there are underlying items).

The assessment of whether these features apply will be based on the facts and circumstances of the participating insurance contracts being measured. To the extent that these features apply, the entity may be able to justify using dividend class cohorts rather than annual cohorts.

If not, it should be noted that the annual cohort approach requires allocation of mutualization cash flows across (likely numerous) annual cohorts, which will require careful consideration.

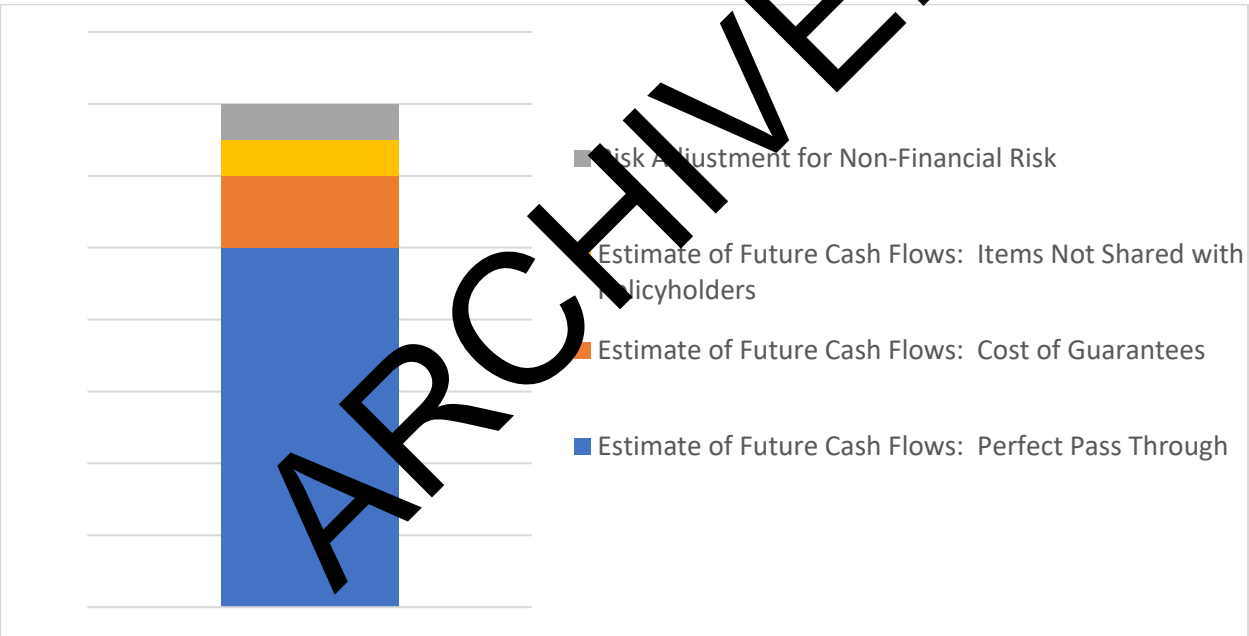
5. Fulfilment cash flows

5.1 Introduction

Under IFRS 17, FCF is the estimate of the present value of future cash flows plus a risk adjustment for non-financial risk (RA). The RA is discussed in Section 5.4.

The estimate of the present value of future cash flows includes the impact of financial risk. For participating insurance contracts in Canada, financial risk arises from the guarantee that policy-holder dividends can never drop below nil, creating a one-sided option. Policy-holders have unlimited upside from positive experience (via higher dividends) but limited downside from negative experience. Measuring the cost of guarantees is discussed in Section 5.3.

The remainder of the estimate of the present value of future cash flows includes amounts for risks that are shared with policy-holders (both amounts that can be passed-through and the cost of guarantees) and amounts for risks that are not shared with policy-holders (e.g., some supplementary benefits and riders). The specific items shared and not shared with policy-holders will vary by portfolio. FCF for items not shared with policy-holders are discussed in Section 5.5.



5.2 Estimate of present value of future cash flows for items shared with policy-holders

There are two typical approaches to measuring the estimate of the present value of future cash flows for items shared with policy-holders for participating insurance contracts in Canada:

1) Implicit approach – "Perfect pass-through" is measured assuming all experience can be absorbed by changes in dividend scales; plus the cost of guarantees, which measures the inability of the dividend scale to absorb changes.
2) Explicit approach – The total is measured by projecting explicit dividend scale changes corresponding to future experience changes; may require a supplement to reflect cost of guarantees depending on the experience changes considered.

There is a third approach to measuring the estimate of the present value of future cash flows for items shared with policy-holders that may be useful for participating insurance contracts with little or no dividend room – i.e., essentially non-participating contracts. The approach is to measure the present value of future guaranteed benefits (using the IFRS 17 "unlinked" discount rate[12]), plus a provision for any residual dividend room and any future "upside" that would be passed through to policy-holders. This additional provision could be significant, as it takes into account scenarios where experience improves and dividend payments are resumed.

Contracts with little or no dividend room are ignored for the remainder of this section.

5.2.1 Implicit approach – perfect pass-through

For groups of participating insurance contracts with significant dividend (pass-through) room, a simple approach to measuring the estimate of future cash flows for items shared with policyholders (before the cost of guarantees) is to project future cash flows assuming current experience and current policy-holder dividend scales persist into the future. This is called the implicit approach because it makes the implicit assumption that future changes in experience will be offset by future changes to policy-holder dividend scales (i.e., perfect pass-through).

A variation is to assume an immediate shock to experience and the consequent adjustment to dividend scales, with future cash flows projected assuming no further changes to experience or the adjusted dividend scales. This is also an implicit approach, as it makes the implicit assumption that any experience changes beyond the immediate shock will be offset by future changes to policy-holder dividend scales.

The discount rate used in the implicit projection would normally be either the current portfolio yield or portfolio yield underlying the policy-holder dividend scales in the valuation (i.e., current or after immediate shock), with any residual timing differences reflected in a dividend stabilization reserve (DSR). Using a "unlinked" discount rate is an application of IFRS 17.B74(b)(i), which says that cash flows that vary based on the returns on any financial underlying items would be discounted using rates that reflect that variability.

A DSR is often used in managing dividend scales. It represents an amount (negative or positive) of experience that has not yet been reflected in dividend scales (e.g., because of smoothing), but will be reflected in the future according to policy-holders' reasonable expectations (PRE). Therefore, the DSR, if used, is part of the perfect-pass-through portion of the estimate of the present value of future cash flows for items shared with policy-holders as a future dividend cash flow (see Section 5.2.3).

The perfect pass-through portion of the liabilities is sometimes called the "PRE portion" and is the policy-holders' share of the underlying items. It qualifies as a non-distinct investment component under IFRS 17, as this amount is returned to policy-holders (in the collective) in all circumstances. In a closed block set up at demutualization, it corresponds to the entire closed block.

[12] "Unlinked" discount rates are the discount rates applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items.

5.2.2 Explicit approach

Under the explicit approach, future cash flows are projected based on assumed experience for the items shared with policy-holders, together with an explicit projection of the corresponding policy-holder dividend payments (see Section 5.2.3). The projection would include the impact of any dividend smoothing mechanisms as well as a view of how experience might emerge in the future.

The explicit approach might be completed on a deterministic (i.e., one projection path) or stochastic (i.e., numerous projection paths) basis. A deterministic basis can provide insight into how dividends will emerge in the future under a particular set of experience assumptions; however, it will not likely include the full cost of guarantees. Stochastic projections of investment returns that adhere to the market consistent requirements of IFRS 17 (see Section 5.3.1) would yield an amount that includes the cost of guarantees directly.

Regardless of how the explicit approach is applied, the change in the cost of guarantees would need to be separately identified for presentation purposes (see Section 7) as an insurance finance expense for groups measured under the GMA or as an adjustment to the CSM for groups measured under the VFA.

5.2.3 Future dividend cash flows

In addition to the projection of guaranteed cash flows (e.g., premiums, surrender benefits, death benefits, etc.), estimates of future cash flows for participating insurance contracts include cash flows for projected policy-holder dividend payments and other non-guaranteed benefits. The projection of non-guaranteed benefits would be consistent with the company's participating account management policy and dividend policy and would consider PRE. The concept of PRE provides a framework for incorporating discretionary payments into the measurement of obligations to be reflected in the FCF per IFRS 17.B65(c). If measured under the GMA, IFRS 17.B98 requires an explicit articulation that PRE is the basis for determining discretionary cash flows (i.e., the commitment) so that any future changes in PRE can be reflected in the CSM (IFRS 17.B99) (see Section 7.2.2).

A common expression of PRE in Canada is that policy-holder dividend scales are adjusted to pass through the impact of changes in experience items shared with policy-holders (e.g., mortality, lapse, investment, expense) to the extent that dividend room is available. Dividend scale adjustments may be smoothed from year-to-year, but over time, all experience is passed through. Also important is the concept of dividend class discussed in Section 4.2.1.

Under IFRS 17, consideration of PRE in Canada is widened under IFRS 17.B67–B68 ("contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts"). In particular, IFRS 17.B68 requires consideration of whether there are obligations to future policy-holders in addition to the obligations to current policy-holders. If so, such amounts would be included in the estimate of future cash flows under IFRS 17 (rather than in surplus). Consideration of whether there are obligations to future policy-holders would consider all legal and constructive obligations arising from applicable statutes, regulations, and guidelines as well as contractual terms and representations made to policy-holders (per IFRS 17.2).

5.2.4 Post-dividend cash flows

In some Canadian participating insurance contracts, policy-holders can apply dividend payments to purchase additional life insurance coverage (e.g., paid-up additions (PUA)). Modelling these post-dividend cash flows can be complex, requiring assumptions about the proportion of policy-holders who elect various dividend options and the price that will be charged for the additional coverage. Therefore, the actuary might take a simplified approach that avoids explicit projection of PUA cash flows but nevertheless takes into account the potential impact on the estimates of future cash flows. In particular, absent significant flexibility in setting premiums for future PUA coverage, the cost of guarantees is likely to be higher if policy-holders elect PUA than if they do not (see Section 5.3).

5.2.5 Expense cash flows

IFRS 17 limits the expenses included in the estimates of future cash flows to those that are "directly attributable" to the portfolio or "relate directly to the fulfilment of the contract."

However, IFRS 17.B65(m) indicates that all costs specifically chargeable to policy-holders are included in future cash flows. If expense experience is shared with policy-holders, such expenses are "charged" to policy-holders via an adjustment to the dividend scale. Therefore, whether the implicit or explicit approach is used, projected expense cash flows included in the estimates of future cash flows would be consistent with the expenses shared with policy-holders. Any change in the level of such expenses would be offset by an adjustment to policy-holder dividends, with no impact on the estimates of future cash flows. However, the level of expenses may affect the cost of guarantees as it affects the amount of dividend room available (see Section 5.3).

See Section 5.5.3 for a discussion of the case where expense experience is not shared with policy-holders.

5.2.6 Income tax cash flows

Under IFRS 17, future income tax cash flows are excluded from the estimates of future cash flows unless they are specifically chargeable to policy-holders (IFRS 17.B66(f)).

If income tax experience is shared with policy-holders, such income taxes are "charged" to policy-holders via an adjustment to the dividend scale. Therefore, whether the implicit or explicit approach is used, projected income tax cash flows included in the estimates of future cash flows would be consistent with the amounts shared with policy-holders.

If income tax experience is not shared with policy-holders, there would be no impact on dividends and the future tax cash flows would be excluded from the estimates of future cash flows.

Dividends from Canadian companies that are received by Canadian companies are not subject to income tax. This improvement in after-tax investment returns would typically be shared with policy-holders and therefore would have no impact on the perfect pass-through portion of the estimates of future cash flows. However, the additional return would reduce the cost of guarantees (see Section 5.3) as there is more dividend room available.

5.2.7 Reinsurance treaties

Under IFRS 17, reinsurance contracts held (i.e., reinsurance ceded) are in separate portfolios from insurance contracts issued by the entity.

In participating insurance, a reinsurance treaty could be part of the underlying items if cash inflows and outflows flow through to policy-holder dividend scales. In such a case, the cash flows of the reinsurance treaty affect the cash flows of the underlying contracts, and care would be taken not to omit or double count the effect of the reinsurance.

5.3 Measuring the cost of guarantees

In reflecting the effect of financial risk in the estimates of future cash flows, IFRS17 requires, among other general requirements (e.g., unbiased, current), that the estimates of any relevant market variables be consistent with observable market prices for those variables (IFRS17.33(b)). This is expanded in IFRS 17.B44, which requires the entity to maximize the use of observable inputs and not substitute its own estimates for observable market data. If financial variables are needed where no observable market variable exists, the estimates would be as consistent as possible with observable market variables.

Under IFRS 17, the provision for financial risk represents a "market consistent" measure of the risk, which includes the cost of financial risk and would typically be higher than a real-world "best estimate" provision. The total provision for financial risk is included in the estimate of the present value of future cash flows with no separate risk adjustment.

Guarantees on participating insurance contracts involve complex interdependencies among cash flows, and a non-linear relationship between cash flows and financial risk variables (the one-sided option). Under such circumstances, IFRS 17 suggests that stochastic modelling/scenario testing techniques may be required to reflect the effect of financial risk in the estimate of the present value of future cash flows (IFRS 17.B39, B48).

In stochastic modelling/scenario testing of financial risk variables, future cash flows are projected for each integrated scenario path and discounted at the scenario-specific discount rate, giving an estimate of the present value of future cash flows for each scenario.

Projections of future cash flows can be done on a whole contract basis as in the explicit approach (see Section 5.2.2), including future dividend cash flows (see Section 5.2.3). If so, the financial risk provision would be included in the mean (i.e., CTE(0)) of the scenario-specific values (see Section 5.3.1). Alternatively, future cash flows can be limited to a projection of payments under the guarantees (e.g., as a top-up to the implicit approach (see Section 5.2.1)), in which case the provision for financial risk would be CTE(0) of the scenario-specific values.

Stochastic modelling can be complex and time consuming, and therefore might not be warranted if the cost of guarantees is low. Considerations in assessing the level of the cost of guarantees and possible alternatives to stochastic modelling when the cost of guarantees is low are discussed in Section 5.3.3. A sampling approach to determine a smaller number of representative scenarios may also be a way to reduce the complexity and time required.

5.3.1 Market consistency

As with all techniques related to financial risk, IFRS 17 requires a market consistent approach, and in particular, the measurement of any options and guarantees included in the insurance contracts should be consistent with observable market prices (if any) for such options and guarantees (IFRS 17.B48). IFRS 17.33(b) and IFRS 17.B42–B53 provide more guidance on the topic of market consistency.

The requirement for market consistency in stochastic modelling/scenario testing is satisfied by using risk-neutral (RN) scenarios.[13] The draft educational note *IFRS 17 Market Consistent Valuation of Financial Guarantees for Life and Health Insurance Contracts* describes how to produce and calibrate RN scenarios on a market consistent basis. Where more than one financial risk variable is involved, integrated scenarios that each have at their core a scenario of RN interest rates would be used. Each RN scenario path drives all the financial risk variables needed, which in turn drives the projection of returns on underlying items and the projection of cash flows under that scenario, and the scenario-specific discount rate. Within each scenario projection, assumptions for non-financial risk variables should be consistent with the scenario and exclude any margin for risk (i.e., "best estimate view" assumptions).

5.3.2 Reflecting the features of guarantees

RN scenarios are calibrated to observable market prices of options and guarantees available in the market. However, the guarantees embedded in participating insurance contracts are not available in the market and have different features than the market instruments to which the RN scenarios are calibrated. For example:

- Guarantees embedded in participating insurance contracts are often not limited to financial risk but are based on a combination of financial variables shared with policy-holders (e.g., mortality, lapse).
- Unlike options available in the market, guarantees embedded in participating insurance contracts are illiquid (the policy-holder cannot withdraw the value of the guarantee).
- Guarantees may apply over the long term only; i.e., losses may be recouped before dividend payments are resumed.
- Market instruments with similar features (e.g., put options) are usually not available for the length of time the guarantee would be in force.
- Experience is shared over dividend classes/cohorts (see Section 4), so the cost of guarantees would be measured at that level.
- Management has discretion over the timing and extent of divided scale changes and the investment strategy of assets underlying the guarantee. This discretion could be used to mitigate potential guarantee costs (provided policy-holders are treated fairly).
- There may be non-guaranteed elements (e.g., PUA purchase rates, contribution to surplus) that can be adjusted to mitigate potential guarantee costs (provided policy-holders are treated fairly).

Though a complex stochastic valuation may be used to estimate the cost of guarantees, it can give a false sense of precision, if, for example, the analysis ignores the considerations above.

Under IFRS 17.B78(c), the entity is required to exercise judgment to assess the degree of similarity between the features of the insurance contracts being measured and the features of the instrument for which observable market prices are available and adjust the provision to reflect the differences between them.

[13] In theory, real-world (RW) scenarios with deflators could also be used.

Possible adjustments are discussed below. The specific adjustments applied will depend on the specific features of the guarantee being measured.

5.3.2.1 Adjustments to RN scenarios

Some adjustments can be made by adjusting the market consistent RN scenario paths. In particular, the risk-free rate in each RN scenario path would be increased by an illiquidity premium to reflect that guarantees embedded in participating insurance contracts are illiquid, while the financial instruments available in the market (to which the RN scenarios are calibrated) are liquid. The illiquidity premium should be consistent with that in the "unlinked" discount rate for other illiquid components of the contracts.

This adjustment is discussed further in the draft educational note *IFRS 17 Market Consistent Valuation of Financial Guarantees for Life and Health Insurance Contracts*.

5.3.2.2 Adjustments to projected dividend payments

Other adjustments might be made through the projection of policyholder dividend payments along each scenario path.

For example, where consistent with PRE, projected dividend payments would reflect that losses from guarantees would be recouped before dividend payments resume (if experience improves). This would reduce the cost of guarantees in scenarios of adverse experience followed by favourable experience.

Projecting dividend payments in unusual scenarios is a key challenge, as there may be little or no experience to inform the projection of management actions in setting dividend scales or making other changes (e.g., changes to PUA purchase rates or contributions to surplus) to mitigate the cost of the guarantee. The actuary would be guided by PRE, which, if measured under the GMA, will be explicitly articulated as the basis for determining discretionary cash flows (see Section 5.2.3).

5.3.2.3 Other adjustments

Other adjustments to stochastic modelling/scenario testing results could be required under IFRS 17.B78(c).

For example, guarantees in participating insurance contracts are often based on the combination of financial risk and non-financial risk variables (i.e., there is not a separate guarantee for each variable), but RN scenarios only include financial risk variables. Therefore, estimates of the cost of guarantees based solely on scenarios of financial risk variables may require adjustment. The interaction between financial and non-financial risk also affects the estimation of the RA (see Section 5.4).

A market consistent measurement would take into account all available relevant market information. One such piece of information is the price that entities charge for providing these guarantees. Though not definitive, any available information could be useful as a reasonableness check or to identify appropriate adjustments to an estimate of the cost of guarantees measured using stochastic modelling/scenario testing.

For example, one adjustment that might be warranted is an adjustment to dampen the sensitivity (to changes in current interest rates) of the cost of guarantees measured using stochastic modelling/scenario testing. Though not insensitive to changes in interest rates, the

cost of guarantees embedded in participating insurance contracts would be less sensitive than the price of market instruments with similar features (e.g., put options) when guarantees are over the long run, especially if the guarantee is combined with non-financial risk variables. Possible methods to accomplish this include:

- adjust (reduce) volatility parameters in the RN scenarios; and
- adopt a "moving average" approach to estimating the cost of guarantees from period-to-period, where the estimated cost of guarantees for a period is the estimate for the previous period plus a portion of the change over the period based on stochastic modelling/scenario testing.

5.3.3 Alternatives to stochastic modelling/scenario testing

Stochastic modelling including the projection of future dividend payments can be complex and time consuming, and therefore may not be warranted if the cost of guarantees is low (e.g., in small blocks) and can be estimated using simpler techniques. Techniques for assessing the cost of guarantees for the purpose of deciding whether a simpler technique is warranted include:

1) Pricing interest rates

- Pricing interest rates used to determine the premiums and guaranteed benefits may provide an indication of the level of investment returns that would trigger guarantee costs.
- This approach only considers implied guarantees on investment returns and does not consider the impact of non-financial risk factors in the guarantee (e.g., mortality).

2) Implied internal rate of return

- An implied internal rate of return (IRR) can be calculated by removing dividends from the projection of cash flows and then determining the IRR that equates the present value of the guaranteed cash flows to the perfect pass-through amount under the implicit approach (see Section 5.2.1).
- This approach ignores post-dividend cash flows (e.g., PUA growth) and only provides a level IRR over the projection period.

3) Stochastic discount rates with no dividends

- Similar to 2) above, a projection of guaranteed cash flows plus a tapering of dividends from current levels to nil could be discounted at scenario-specific discount rates (where scenarios are market consistent) and compared to the perfect pass-through amount under the implicit approach (see Section 5.2.1).
    - There is no cost of guarantee in scenarios where the present value of guaranteed cash flows is less than the perfect pass-through amount. In these scenarios, the estimate of future cash flows would be the perfect pass-through amount.
    - The guarantee bites in scenarios where the present value of guaranteed cash flows is greater than the perfect pass-through amount. In these

scenarios, the estimate of future cash flows would be the present value of guaranteed future cash flows.

- The estimate of the present value of future cash flows including guarantee costs would be the average across all scenarios. The implied guarantee cost would be the difference between this total and the sum of the perfect pass-through amounts. For example, the following are the results assuming five scenarios are used with a perfect pass-through amount of $100.

Scenario	Unfloored liability	Floored liability	Comment
1	80	100	No costs
2	110	110	$10 of costs
3	90	100	No costs
4	95	100	No costs
5	75	100	No costs
Average	**N/A**	102	$2 of costs

- The key approximations in this approach are:
  - it ignores post-dividend cash flows (e.g., PUA growth); and
  - it understates the cost of guarantees in scenarios of favourable experience followed by adverse experience, as past dividend payments cannot be collected from policy-holders to pay for future cost of guarantees.

4) Unlinked discount rates with no dividends

- The present value of guaranteed cash flows (i.e., no dividends) using the IFRS 17 unlinked discount rates minus the perfect pass-through amount would be a lower bound for the cost of guarantees. It is a lower bound because it ignores the cost associated with the fact that any favourable experience will be passed-through to policy-holders (i.e., all else equal, the estimate of present value of future cash flows for a participating insurance contract with no dividend room is higher than for a non-participating insurance contract).

5) Price charged for guarantee

- The price the entity charges for the guarantee can be estimated from the contribution to surplus embedded in the pricing basis. Though not definitive, the price charged for the guarantee could be indicative of the entity's view of the long-term cost of the guarantee.

6) Deterministic scenario testing

- Deterministic RW scenario testing can provide an indication of the future economic conditions that would trigger guarantee costs.

These techniques can be used to identify blocks of business where guarantees are unlikely to come into the money and the cost of guarantees might be reasonably estimated without stochastic modelling.

A caution – the cost of guarantees can vary significantly from period to period, so estimates using simpler techniques might need to be reviewed frequently.

5.4 Risk adjustment for non-financial risk for items shared with policyholders

The risk adjustment for non-financial risk (RA) under IFRS 17 is intended to be an adjustment to "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" (IFRS 17.37). A discussion of the RA under IFRS 17 is covered in the draft educational note *IFRS 17 Risk Adjustment for Non-Financial Risk for Life and Health Insurance Contracts*.

An RA on participating insurance contracts is required to the extent that adverse non-financial experience (e.g. mortality, lapse, expense, etc.) would not be offset by a reduction in policy-holder dividends. All else being equal, the IFRS 17 RA would be higher for policies with less pass-through room available in the policy-holder dividend scale and lower for policies with more pass-through room available.

Where the guarantees embedded in participating insurance contracts combine financial and non-financial risk variables, the actuary would take care to reflect the interrelationship of the different variables and not to double count sources of policy-holder dividend room.

The attribution between financial risk (in the estimate of the present value of future cash flows) and non-financial risk (in the RA) is unclear when guarantees combine financial and non-financial risk variables, however, it is necessary for presentation under IFRS 17 (see Section 7) and for Canadian regulatory capital requirements (LICAT/CARLI). The actuary would choose a systematic and rational basis for this attribution that respects market consistent principles for the measurement of financial risk as discussed in the draft educational note *IFRS 17 Market Consistent Valuation of Financial Guarantees for Life and Health Insurance Contracts*. For example, the provision for financial risk includes non-financial risk variables without margin.

5.5 Items not shared with policy-holders

5.5.1 Amounts (dividends) on deposit

Experience on amounts (dividends) on deposit (AoD) may or may not be shared with policy-holders or may be partially shared. Amounts shared with policy-holders are discussed in Sections 5.2-5.4.

If the AoD could remain in force after its base policy lapses, the AoD may be a distinct investment component (see IFRS 17.31–32), in which case it would be separated from the insurance contract and follow the measurement and presentation requirements for investment contracts (IFRS 9).

The FCF for the portion of AoD that is not shared with policy-holders depends on whether credited rates are linked to returns on the assets underlying the AoD (i.e., there is an underlying item for the AoD) or credited rates are unlinked.

- If the credited rates are linked, the FCF would be:
    - the present value of the expected run-off of the AoD balance at the linked discount rate, where the AoD balance is accumulated at the linked discount rate less the spread taken by the entity; plus
    - the cost of any guaranteed minimum credited rates; plus
    - provision for expenses related to AoD; plus
    - RA for the non-financial risk related to the assumed rates of run-off and expenses.
- If the credited rates are unlinked, the FCF would be:
    - the present value of the expected run-off of the AoD balance at unlinked discount rates, where the AoD balance is accumulated at credited rates that are consistent with the unlinked discount rate path (reflecting any spread taken by the entity); plus
    - the cost of any guaranteed minimum credited rates; plus
    - provision for expenses related to AoD; plus
    - RA for the non-financial risk related to the assumed rates of run-off and expenses.

In practice, the FCF for AoD might be estimated more simply as a percentage of the account value that depends on the duration of the AoD, the spread taken by the entity and the risks in the block. The RA would be separately identified for disclosure purposes if significant.

Under IFRS 17, there is no separate line on the statement of financial position for "amounts on deposit." The FCF for AoD in scope of IFRS 17 is reported with insurance contract liabilities (unless it is a distinct investment component, in which case the AoD balance is reported with investment contract liabilities).

5.5.2 Policy loans

Experience on policy loans may or may not be shared with policy-holders. Amounts shared with policy-holders are discussed in Sections 5.2–5.4.

The treatment of policy loans in presentation (e.g., contribution to revenue) is the same as that for investment components. For example, loans made to policy-holders are not reported as insurance service expense, and policy loan repayments are not reported as revenue.

FCFs for policy loans would reflect the difference between the rate of interest charged on policy loans and unlinked discount rates, assuming some rate of policy loan repayment.

Under IFRS 17, there is no separate line on the statement of financial position for "policy loans." The (negative) FCF for policy loans is reported with insurance contract liabilities.

5.5.3 Expenses (or other experience factors) not shared

For some blocks of participating insurance contracts, some experience factors may not be shared with policy-holders. A common example is expenses.

When expense experience is not shared with policy-holders, some level of expenses (which could be nil) is "charged" to policy-holders via reducing the policy-holder dividend scales. Cash flows for these expenses would be included in the perfect pass-through portion of the liabilities under the implicit approach (see Section 5.2.5).

Therefore, the FCF would be adjusted by the present value (at unlinked discount rates) of the difference between projected actual expenses and the expenses charged in the dividend scales. This adjustment would have a component for RA, which would be separately identified if significant.

In this context, "actual" expenses are directly attributable expenses (perhaps adjusted for the impact of inflation per IFRS 17.59), without double-counting of the expenses attributed to other components of the liability (e.g., AoD, supplementary benefits and riders).

5.5.4 Supplementary benefits and riders

Experience on supplementary benefits and riders may or may not be shared with policy-holders or may be partially shared. Amounts shared with policy-holders are discussed in Sections 5.2–5.4.

Where not shared, the FCF would be measured in the same manner as if it were a non-participating insurance contract, i.e., estimates of future cash flows discounted at unlinked discount rates, plus provision for any financial risk, plus RA.

5.5.5 Market conduct provisions

For some blocks of participating insurance, there may be a cost of market conduct settlements that is not shared with policy-holders. If so, FCF would be measured in the same manner as if it were a non-participating insurance contract, i.e., estimates of future cash flows discounted at unlinked discount rates, plus provision for any financial risk, plus RA.

5.5.6 Liability for incurred claims

The liability for incurred death claims on participating insurance contracts is usually small, reflecting the liability for death claims incurred but not yet paid.

The liability for waiver of premium claims incurred (on disability) could be more significant. If experience on waiver claims is shared with policy-holders, it is covered in Sections 5.2-5.4.

If not shared, the liability for incurred waiver (disability) claims would be measured in the same manner as on a non-participating insurance contract, i.e., estimates of future cash flows discounted at unlinked discount rates plus RA.

6. Contractual service margin

This section discusses the measurement of the CSM at initial recognition and at transition to IFRS 17, and the interaction with surplus in the participating accounts. Changes that adjust the CSM are discussed in Section 7.

6.1 CSM at initial recognition

The CSM at initial recognition of a contract is a measure of the unearned profit in the contract. The initial CSM is the same whether using the GMA or the VFA.

For participating insurance contracts in Canada, the CSM at initial recognition comprises:

- the present value of contributions to surplus, measured consistently with the measurement of the perfect pass-through portion of the FCF (see Section 5.2.1); minus
- an appropriate allocation of the cost of guarantees and RA, which will be measured at the level of aggregation where experience is shared (i.e., dividend class – see Section 4.2.1); plus
- if any, contributions to profit from items not shared with policyholders, e.g.:
    - any expected profits (not shared) on future AoD, which would be nil if post-dividend cash flows are ignored;
    - expected profits if expenses (or other experience factors) charged in the dividend scale are higher than expenses (or other experience factors) expected to be allocated to the participating account; and
    - any expected profits (not shared) on supplementary benefits and riders.

If less than zero, the CSM at initial recognition is set to zero and the contract is onerous.

Note that for items shared with policy-holders, the conditions in effect on the date of issue of a contract have less effect on the initial CSM than they would for items not shared with policy-holders because of the sharing of risk (IFRS 17.B67–B71). For example, say the current dividend interest rate for the dividend class is 5% and current interest rates are 3%. The cost of guarantee in the initial CSM of a new contract will not be measured as if that contract begins with its guarantee 2% "in-the-money." Rather, it will be based on an allocation of the cost of guarantee for the dividend class as a whole.

6.2 CSM at transition to IFRS 17

The CSM at transition to IFRS 17 would be measured retrospectively (i.e., as if IFRS 17 had been in effect since inception of the group), unless it is impracticable to do so, in which case the entity chooses between the modified retrospective approach (if reasonable and supportable information exists to allow it) and the fair value approach.

The goal of the modified retrospective approach is to come as close to the full retrospective approach as possible, i.e., to estimate the unearned profit as at the transition date. In contrast, the fair value approach is a "fresh start", estimating how much compensation a market participant would require (above the FCF) to take on the obligations at the date of transition.

Under the fair value approach, the CSM is the amount in excess of the FCF that a market participant would require to take on the obligations. However, if the characteristics of a market participant are similar to those of the entity, the CSM might be estimated by starting with the amount the entity requires (i.e., the CSM at initial recognition (see Section 6.1)) and adjusting where necessary. The components of the CSM include the following:

- **Items shared with policy-holders:** The present value of future contributions to surplus, minus an appropriate allocation of the cost of guarantees and RA.
    - The future contributions to surplus required by a market participant might be different than the contributions to surplus charged by the entity, e.g., if the cost of capital is different.

- The cost of guarantees should already reflect a market view of the cost, so no adjustment would be made for that portion unless the impact of non-financial variables is significantly different than a market participant would recognize.

- **Items not shared with policy-holders:** Expected profits.
  - Amounts required by a market participant to provide for the cost of capital (or profit) on items not shared with policy-holders might be different than future profits expected by the entity.

At transition, if profits from the ancillary block have previously been transferred out of the participating account, the IFRS 17 liability (including CSM) might exceed the ancillary block assets at transition. If so, it might be convenient to transfer the deficiency into the ancillary block at transition to facilitate the separate reporting requirements for the participating accounts in the ICA after transition.

See the draft educational note *IFRS 17 Fair Value* for additional considerations.

6.3 Coverage units

Coverage units are the metric by which CSM (unearned profit) is released into profit as insurance contract services are provided (see IFRS 17.B119). For Canadian participating insurance contracts with underlying items, the policy-holders' share of the underlying (i.e., the perfect pass-through amount of the FCF[14]) might be a reasonable coverage unit for the insurance and investment-related (VFA) or investment-return (GMA) services provided by the items shared with policy-holders.

Provision of insurance contract services related to items not shared (e.g., AoD, supplementary benefits and riders, GMA contracts without underlying items) might better be represented by different coverage units (e.g., AoD balance, coverage under supplementary benefits, corresponding non-par coverage unit for GMA).

See the draft educational note *IFRS 17 – Coverage Units for Life and Health Insurance Contracts* for additional considerations.

6.4 Participating account surplus

The CSM is a measure of unearned (future) profits in the participating accounts. As that profit is earned, the amounts become participating account surplus, which is analogous to retained earnings in a shareholder account. Transfers from participating account surplus to other accounts (shareholder account in a stock/shareholder company and non-participating account in a mutual company) may be made periodically, subject to the restrictions in the ICA/QIA.

Under pre-IFRS 17 financial reporting standards, the present value of future profits in the participating accounts and amounts owed to future policy-holders (IFRS 17.B67–B71) are in participating account surplus. At transition to IFRS 17, these portions of surplus become liabilities (CSM for future profits and/or FCF for amounts owed to future policy-holders), and participating account surplus will reduce, leaving the accumulated value of past profits less amounts previously transferred out of the participating accounts.

[14] Excluding amounts owed to future policy-holders (IFRS 17.B119A).

Going forward, the CSM will be released into participating account surplus as insurance contract services are provided (see Section 6.3). The resulting pattern of profit/loss in the participating account will depend on whether the group is measured using the VFA or the GMA (see Section 7) and whether accumulated surplus is included in the underlying items or not.

7. Financial reporting (presentation)

This section considers the presentation in the financial statements under IFRS 17 for Canadian participating insurance contracts measured under the VFA or the GMA.

7.1 Contracts measured under the variable fee approach

7.1.1 Determination of underlying items

The determination of the pool of underlying items is a key consideration for the application of the VFA. As discussed in Section 3.2, for participating insurance contracts that qualify for the VFA, the underlying items will either be:

- the participating account (including items not shared with policyholders[15]); or
- the fund for items shared with policyholders (e.g., closed block or "90/10 fund").

7.1.2 Identifying the components of B104

Identifying the components of IFRS 17.B104 is needed to apply the presentation requirements in IFRS 17.B111–B114 (see Section 7.1.3).

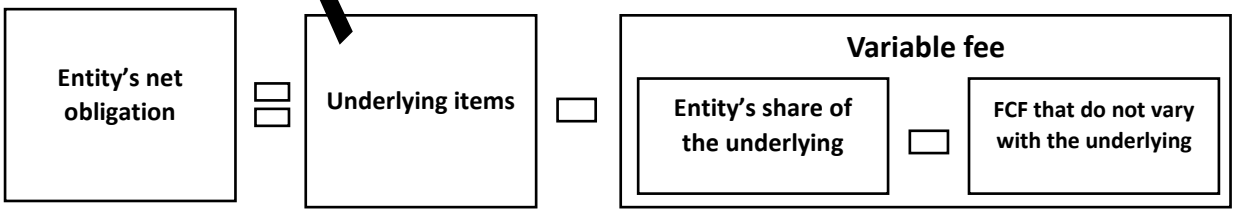
According to IFRS 17.B104, "the entity's obligation to the policyholder is the net of:

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

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

   i. the amount of the entity's share of the fair value of the underlying items, less

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



Since the pool of underlying items is made up of the policy-holders' share and the entity's share, the picture can be rearranged to show that the entity's obligation to the policy-holders is the policy-holders' share of the underlying items plus the FCF that do not vary with the underlying items, as expected.

[15] Accumulated surplus might be included or excluded.

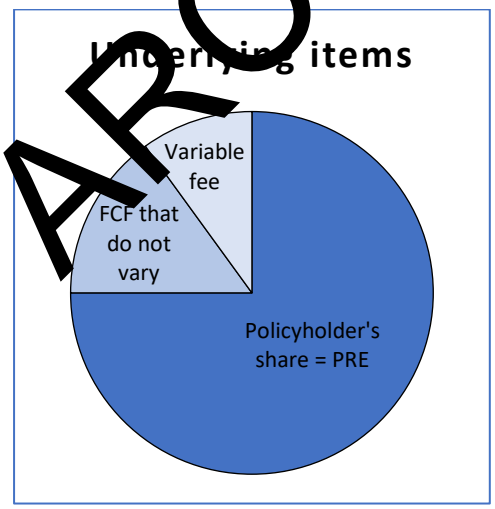
The policyholders' share of the underlying items is the perfect pass-through portion (or PRE portion) of the items shared with the policy-holders. The FCF that do not vary with the underlying items are:

- cost of guarantees and RA related to the items shared with policyholders; and
- items not shared with policy-holders.

7.1.2.1 Underlying items = participating account

When the pool of underlying items is the participating account[16], the FCF that do not vary with the underlying items are part of the underlying items. This unintuitive case is not explicitly discussed in IFRS 17; however, the same logic applies. The components of B104 are as follows:

- Policyholders' share of the underlying = perfect pass-through (PRE) portion of items shared with policy-holders
- Entity's share of the underlying = variable fee + FCF that do not vary with the underlying
- Variable fee = deferred profit (contribution to future surplus less amounts to pay for FCF that do not vary with underlying)
- FCF that do not vary with underlying = cost of guarantees and RA for items shared with policy-holders + items not shared with policy-holders



Note: This is only for illustration purposes and does not represent the size of each component.

Entity's share = variable fee + FCF that do not vary with underlying

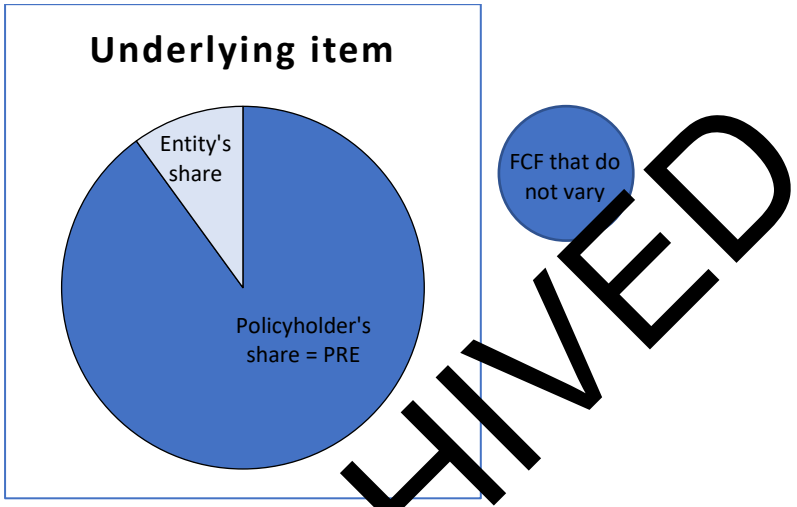
Entity's obligation to policy-holders = policy-holders' share of the underlying + FCF that do not vary with underlying

[16] This under the simplified example where the entire par account is the underlying item. In some cases, contracts within the par account that do not qualify for the VFA may be excluded.

7.1.2.2 Underlying items = fund for items shared with policy-holder

When the pool of underlying items is limited to the items shared with policyholders, the components of IFRS 17.B104 are as follows:

- Policy-holders' share of the underlying = 100% of underlying for closed block
- Entity's share of the underlying = nil for closed blocks
- Variable fee = entity's share of underlying minus FCF that do not vary with underlying
- FCF that do not vary with underlying = cost of guarantees and RA for items shared with policy-holders + items not shared with policy-holders



Note: This is only for illustration purposes and does not represent the size of each component.

7.1.3 Presentation under the VFA

Paragraphs IFRS 17.B111–B113 cover the treatment of the different components in paragraph IFRS 17.B104 under the VFA.

7.1.3.1 IFRS 17.B111

IFRS 17.B111 says, *"changes in the obligation to pay the policyholder an amount equal to the fair value of the underlying items (paragraph B104(a)) do not relate to future service and do not adjust the contractual service margin."*

Under this paragraph, all investment income on underlying items (assuming fair value through profits or loss) is offset by insurance finance expense for the change in the underlying items (both the policy-holders' share and the entity's share). So, for everything in the underlying items, investment results will be nil, and all profit/loss will come through insurance service results.

If the pool of underlying items is the participating account (see Section 7.1.2.1), there will be no investment results.[17]

If the underlying items exclude FCF that do not vary with the underlying (see Section 7.1.2.2), investment income on assets supporting the amounts outside the underlying items will not be

[17] Other than investment income on accumulated surplus if accumulated surplus is outside the underlying items.

offset by insurance finance expense because the change in FCF related to financial risk goes through CSM (see Section 7.1.3.3) under the VFA. Though a portion of that change would flow into profit/loss via the CSM amortization, it is unlikely to match the investment income on the supporting assets and is presented in insurance service results rather than investment results.

7.1.3.2 IFRS 17.B112

IFRS 17.B112 states, "changes in the amount of the entity's share of the fair value of the underlying items (paragraph B104(b)(i)) relate to future service and adjust the contractual service margin, applying paragraph 45(b)."

Under this paragraph, the total change in the entity's share of the underlying adjusts the CSM.

In the case where the underlying items excludes FCF that do not vary with the underlying (see Section 7.1.2.2), this paragraph retains the relationship between the PRE portion of the liability for items shared with policy-holders and the CSM. That is, the portion of CSM related to the underlying items is always equal to the entity's share of the underlying items.

In the case where the underlying items is the participating account (see Section 7.1.2.1), this paragraph includes everything other than the PRE portion of the items shared with policy-holders. After the application of B113 (see Section 7.1.3.3), this paragraph acts as a balancing item so the total liability (including CSM) equals the underlying items.

7.1.3.3 IFRS 17.B113

IFRS 17.B113 covers the treatment of changes in FCF that do not vary with the underlying items. Changes related to financial risk adjust the CSM (IFRS 17.B113(b)), except to the extent the risk mitigation option is applied, or the group is onerous (i.e., there is no CSM). Other changes follow the treatment under the GMA (IFRS 17.B113(a)), so changes that relate to future service adjust the CSM (unless the group is onerous) and changes that relate to past or current service go through profit and loss as insurance contract revenue or insurance service expense. Unlike the GMA though, all changes in FCF that adjust the CSM are measured using current discount rates rather than locked-in discount rates.

The treatment of changes in FCF that do not vary with the underlying items is as follows:

- **Cost of guarantees**: Adjusts CSM (financial risk)
- **RA for items shared with policy-holders**: Release of RA in the period is insurance revenue[18]; changes related to future service adjust CSM
- **Items not shared with policy-holders**: Release for provision of services in the period is insurance revenue; changes related to future service adjust CSM; changes related to financial risk adjust CSM.

7.1.3.4 Insurance service results

As a result, the following items will comprise insurance service results:

- CSM amortization in the period (revenue)

[18] Portion of change related to the time value of money would adjust CSM if disaggregated (choice under IFRS 17.81).

- Release of RA for items shared with policy-holders (revenue)
- Release of RA for items not shared with policy-holders (revenue)
- Payments under a guarantee for items shared with policyholders (expense)
- Experience adjustments (non-financial risk, not investment components) on items not shared with policy-holders (e.g., profit for expenses not shared) with expected as revenue and actual as expense
- Change in liability for incurred claims that are not shared with policy-holders (expense)
- For onerous groups, amounts that would adjust CSM if the group was not onerous (expense)
- Amortization of insurance acquisition cash flows (with equal and offsetting amounts in revenue and expense) to the extent not shared with policy-holders

Note that unless the guarantee occurs, there is no revenue or expense reported for the PRE portion of items shared with policy-holders, because they are investment components.

7.2 Contracts measured under the general measurement approach

7.2.1 Determination of underlying items

Participating insurance contracts measured under the GMA may or may not have underlying items. If there are no underlying items, presentation under the GMA is the same as it would be for non-participating contracts measured under the GMA.

If there are underlying items, it would be the fund for items shared with policy-holders, and the policy-holders' portion of the fund is an investment component.

7.2.2 Presentation under the GMA

IFRS 17.B98–B100 deal with discretionary cash flows. IFRS 17.B98 states that "an entity shall specify at inception of the contract the basis on which it expects to determine its commitment under the contract." Also, IFRS 17.B99, "an entity shall use that specification to distinguish between the effect of changes in assumptions that relate to financial risk on that commitment (which do not adjust the contractual service margin) and the effect of discretionary changes to that commitment (which adjust the contractual service margin)."

For Canadian participating products measured under the GMA, policy-holder dividends would be considered discretionary cash flows. Under IFRS 17.B99, the entity needs to specify the basis under which dividends will be paid (i.e., PRE) at inception of the contract. In the future, if actual dividend payments are different than existing PRE, or if PRE is changed, the effect of such changes adjust the CSM rather than being recognized in profit or loss.

IFRS 17.B128(c) states that "changes in the measurement of a group of insurance contracts caused by changes in the value of underlying items (excluding additions and withdrawals) are changes arising from the effect of the time value of money and financial risk and changes therein." Therefore, investment income on the underlying items will be offset by insurance finance expense for the increase in the underlying items. Only experience that is not passed to policy-holders (e.g., if guarantees occur), or that is outside the underlying items, is recognized as insurance revenue or expense.

Items outside the underlying items are treated the same way as non-participating products measured under the GMA.

7.3 Illustrative examples

In order to help illustrate the concepts presented within this section, simple examples under both the VFA and GMA measurement models have been created. These simple illustrative examples can be found in the following Excel spreadsheet.