Educational Note

Application of IFRS 17 Insurance Contracts

Actuarial Guidance Council

October 2021

Document 221117

Ce document est disponible en français

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, property and casualty insurance, and workers' compensation areas

From: Steven W. Easson, Chair
Actuarial Guidance Council

Les Rehbeli, Chair,
International Insurance Accounting Committee

Date: October 21, 2021

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

International Financial Reporting Standard 17 (IFRS 17) will be effective in Canada for fiscal years beginning on or after January 1, 2023.

In preparation for this new standard, the CIA has reviewed the final version of the International Actuarial Note 100 (IAN 100) by the International Actuarial Association (IAA), and has decided to adopt it as a CIA educational note.

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

Since the IAN 100 was originally published by the IAA, it is presented in a different format and may use different terminology than that used in the *Standards of Practice* and educational notes developed by the Actuarial Standards Board/CIA.

The CIA has identified a number of clarifications that are needed to several of the topics discussed in the final IAN 100[1]. The CIA decided not to modify any of the chapters in the IAN 100 directly in order to avoid confusion with the official version of IAN 100 and to avoid the burdensome requirement to coordinate future updates with any IAA revisions to IAN 100. Rather, the CIA has noted these clarifications in the preamble below and encourages members to review these clarifications in conjunction with the core IAN 100 document that follows. Any direct quotes from the IAN 100 are in quotation marks in the preamble below.

For ease of reference, the sections referred to in the list below are highlighted in green within IAN 100, so that a reader can easily identify and cross-reference those sections in the IAN 100 where a clarification is needed with the list below. It should be noted that only significant

[1] These clarifications have been communicated to the IAA during their drafting phases for their consideration in future updates to IAN 100.

clarifications are included, i.e., where the absence of a clarification would result in an inappropriate interpretation of the particular question and answer. The CIA did not focus on minor clarifications, such as typographical errors and labelling issues (unless the error would otherwise inappropriately change the interpretation of the guidance).

The creation of this cover letter and educational note has followed the Actuarial Guidance Council (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 educational note received final approval for distribution by the AGC on October 12, 2021.

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

This educational note 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.

If you have any questions or comments regarding this process, please contact Steven W. Easson, chair of the AGC or Les Rehbeli, chair of the IIAC. If you have any questions or comments on technical detail, please contact, as applicable, the chairs of the Committee on Life Insurance Financial Reporting, the Property and Casualty Insurance Financial Reporting Committee, or the Committee on Worker's Compensation. These individuals can be reached at their email addresses on the CIA website or by contacting the CIA head office at guidance.feedback@cia-ica.ca.

SWE, LR

Preamble: CIA Clarifications to IAN 100:

The following clarifications to the IAN 100 are needed. These are categorized in sequential order, by chapter:

Section A – Introduction to the General Measurement Approach

1. **Section A – Introduction to General Measurement Approach, bullet point (d):**

   This section states that "the illiquidity risk may be included in the discount rate, or alternately, […] as part of the risk adjustment".

   The illiquidity **premium** (emphasis added) for a group of insurance contracts would be included in the discount rate. Any illiquidity risk arising from **uncertainty** in the timing of projected liability cash flows would be included in the risk adjustment for non-financial risk (RA).

   This section also states that "treatment of any asset liability mismatch allowance / reserve could be included in the discount rate or the risk adjustment". IFRS 17 does not include any allowance for mismatch risk (except to the extent consistent with the observable market prices). Refer instead to Q4.3, which states that mismatch risk should be excluded from fulfilment cash flows (FCF).

Chapter 2 – Estimates of Future Cash Flows

2. **Q 2.13 – How are premiums prepaid with interest accretion treated?**

   This question refers to paragraph 27 in IFRS 17, which has been deleted. See paragraph B66A instead.

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

   The second paragraph says "The accounting interpretation of this phrase might, however, result in the need to choose the partition of the business into portfolios suitably to allow an adequate split of currently incurred and future expected costs between those 'directly attributable' to a portfolio and general overhead that is not considered in measurement and presentation of insurance contracts. This is a potentially disputable situation, and there are several possible ways of resolving the situation."

   The IFRS 17 definition of portfolio is contracts with "similar risks managed together". The entity's management of expenses and expense allocations may or may not be relevant to the identification of portfolios.

Chapter 3 – Discount Rates

4. **Q 3.27 – How are cash flows, that do vary based on the returns of any underlying items, discounted?**

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

The key point of this portion of the response is noted in the following paragraph, specifically that "the discount rate is consistent with the rate used for the cash flow projection". Using the risk-free rate (or curve) for both projecting and discounting is one example of a situation. An illiquidity premium could be added to the projection rate(s) and discount rate(s) (or curve) in this situation.

5. **Q 3.38 – Which discount rate is used to measure adjustments that adjust the CSM?**

   The answer provided is that it is the discount rate at initial contract recognition **for cash flows that do not vary with the returns on any underlying items** (emphasis added)**.**

   Paragraph B72(c) says only "discount rates applying paragraph 36 […] determined on initial recognition", which may or may not vary with the returns on underlying items.

6. **Q 3.42 – Which discount rate is used for the amortization of loss component?**

   The answer to this question states that "With respect to the discount rate used for the amortization, IFRS17 does not provide guidance. This discount rate might be chosen equal to the locked in rate at inception. It might also be a locked in rate at the moment that the group of insurance contracts becomes onerous."

   This paragraph implies that the choices are limited to locked in rates. However, since IFRS 17 provides no guidance on the matter, current rates might also be used for this purpose.

Chapter 4 – Risk Adjustment for Non-Financial Risks

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

   The third paragraph says "In some cases, the entity may choose to initially calculate the risk adjustment at a level that incorporates some groups valued under the general measurement approach and others where the liability for remaining coverage is determined under the PAA, i.e., **there is no risk adjustment for the PAA liability for remaining coverage** [emphasis added]. In such cases, there will still be a portion of the risk adjustment attributable to the present value of the future cash flows from unpaid claim liability associated with the PAA groups."

   For greater clarity, a risk adjustment should be considered when calculating the loss component of an onerous group measured under the PAA.

Chapter 5 – Level of Aggregation

8. **Q 5.11 – Are portfolios fixed for all times?**

   The answer states that "A contract is required to be assigned to a group (which is a subset of a portfolio) at initial recognition of the contract, and therefore portfolios **may not cut across groups**" (emphasis added).

   The assignment of contracts to groups can never change, but portfolio definitions can change, and therefore, portfolios may cut across groups over time.

9. **Q 5.29 – What are the implications of aggregation for presentation and disclosure?**

   The second paragraph states that "Paragraph 78 requires the separate presentation of the portfolios of contracts that are issued as assets and that are issued as liabilities."

   The words "issued as" are not in paragraph 78 of IFRS 17. The requirement is for the separate presentation of portfolios of contracts that are assets versus liabilities at each reporting date, regardless of their status at the issue date.

10. **Q 5.30 – How are business combinations and portfolio transfers treated?**

    The answer states that "For intra-group transfers, if it is assessed as a transfer that is not an IFRS 3 business combination, paragraph B93 does not apply. (paragraph 39)."

    According to paragraph 39, paragraph B93 applies to transfers that are not an IFRS 3 business combination. To avoid confusion, for such transfers that are intra-group, paragraph B93 would apply in the unconsolidated statements of the acquiring entity, but paragraph B93 would not apply to the consolidated statements of the group, because there is no transfer at the consolidated level.

Chapter 6 – Contractual Service Margin and Loss Component

11. **Q 6.2 – How is the CSM determined at initial recognition?**

    The second paragraph says, "This negative liability is eliminated at contract inception by the creation of a CSM…"

    In this context, "contract inception**"** means the date of initial recognition of the contract (rather than the issue date).

12. **Q 6.19 – When does the coverage period start and end?**

    The third paragraph gives the example of stop-loss reinsurance, and states that since a reinsurance claim is only triggered when the total claims exceed an attachment point, the coverage, "starts from the point at which a valid claim could be made under the contract and not the underlying individual events."

    The beginning of the coverage period depends on the terms and conditions of the reinsurance contract.

13. **Q 6.25 – What is required to use and the implications of using the financial risk mitigation option?**

    The second last paragraph states that "An entity can choose to apply the option of not adjusting the CSM for some changes in the fair value of underlying items (paragraph 45(b)(i)) or the fulfilment cash flows relating to future service (paragraph 45(c)(i)) if it uses derivatives, non-derivative financial instruments at fair value through profit or loss, or reinsurance contracts held to mitigate the financial risk arising from the insurance contracts, and paragraph B115 applies."

    For greater clarity, an entity cannot choose to apply the risk mitigation option for non-derivative financial instruments used to hedge financial risk of the entity's share of underlying items.

14. Q 6.26 – What is an onerous group and how are they treated in profit and loss?

The answer states that a contract could become onerous after initial recognition if there are "unfavorable changes in the fulfilment cash flows allocated to the group arising from changes in estimates of **future cash flows** [emphasis added] relating to future service."

A contract could also become onerous after initial recognition if there are unfavourable changes in the risk adjustment for non-financial risk relating to future service.

15. Q 6.28 – What is a loss component?

The answer states that "changes in the loss component are recognized as positive or negative insurance expenses."

For clarity, only changes in the loss component that correspond to changes in the liability for remaining coverage are recognized as positive or negative insurance service expenses. This is the case for all changes in the loss component for groups measured under the premium allocation approach. However, under the general measurement approach, changes in the loss component made under paragraph 50(a) do not correspond to changes in the liability for remaining coverage and therefore are not recorded in insurance service expenses.

Section B – Variations to the General Measurement Approach

16. Section B - Variations to the General Measurement Approach

With respect to the application of the variable fee approach (VFA) method, the section states that "As discussed in Chapter 8, the circumstances as to when the VFA may be used are not always straightforward especially for contracts with direct participation features which may well vary by jurisdictions. Although not insurance contracts, investment contracts with discretionary participation features are in scope of IFRS 17 'provided they are issued by an entity that also issues insurance contracts.' **If so, these contracts are measured in the same way as Contracts with Direct Participation Features**." (Emphasis added.)

Investment contracts with discretionary participation features do not automatically or necessarily meet the definition of insurance contracts with direct participation features. Paragraph B101 is applied to make this determination.

Chapter 7 – Premium Allocation Approach

17. Q 7.9 – What is the initial measurement approach to the liability for remaining coverage?

The answer cites paragraph 55a(iii), but the quoted reference is from the May 2017 version of IFRS 17 rather than the June 2020 final. The final 55a(iii) is:

"plus or minus any amount arising from the derecognition at that date of:

1. any asset for insurance acquisition cash flows applying paragraph 28C; and

2. any other asset or liability previously recognised for cash flows related to the group of contracts as specified in paragraph B66A"

18. **Q 7.13 – How should the liability for incurred claims be measured for contracts measured under the PAA?**

    The first sentence should state that "the PAA generally uses the measurement approach for the liability for **incurred claims** under the GMA" (original answer refers to "liability for remaining coverage" instead of "liability for incurred claims").

19. **Q 7.14 – When and how should an onerous contract be recognized?**

    The answer states that "Referring to paragraph 18, unless there are facts and circumstances indicating that the **portfolio** [emphasis added] is onerous, it is not necessary to assess whether any contracts are or may become onerous."

    The word "portfolio" in this sentence is a typo and should be replaced with word "**group**." The assessment referred to in paragraph 18 is made at the group level, not the portfolio level.

Chapter 8 – Contracts with Participation Features and Other Variable Cash Flows

20. **Q 8.1 – What are the types of participating contracts?**

    With respect to part (b) of the answer to this question, as noted above, investment contracts with discretionary participation features do not automatically or necessarily meet the definition of insurance contracts with direct participation features. Paragraph B101 is applied to make this determination.

21. **Q 8.26 – what is the Other Comprehensive Income (OCI) option?**

    The answer includes the following paragraph: "For contracts where financial risk has a substantial effect on the amounts paid to policyholders (i.e., most participating contracts), there is specific guidance for systematic disaggregation. The disaggregation eliminates accounting mismatches with income or expenses included in profit or loss on the underlying items held (paragraph 89)".

    For greater clarity, paragraph 89 only applies to insurance contracts with discretionary participation features where the entity holds the underlying items.

Chapter 9 – Reinsurance

22. **Q 9.8 – How is measurement (i.e. CSM) impacted when there is reinsurance held against a group of underlying insurance contracts that are onerous?**

    The answer states: "Where an entity recognizes a loss on a group of underlying insurance contracts because the underlying insurance contracts are onerous, the entity is required to offset this by recognising a gain on reinsurance contracts held."

    For clarification, the recognition of this offset is subject to two conditions: (1) there is an expected recovery of claims on the underlying contracts from the reinsurance contracts held (technically based on the probability-weighted scenarios of claims), and (2) the relevant reinsurance contracts held are recognized on or before the recognition of the underlying insurance contracts.

23. Q 9.11 – How is counterparty risk of non-performance by the issuer of reinsurance contracts reflected in reinsurance contracts held?

The final paragraph of this answer addresses whether risk adjustment should include any adjustments for counterparty non-performance risk. The answer notes that since counterparty non-performance risk is not transferred to the reinsurer, the risk adjustment would not include an adjustment for this risk. However, an alternate view is also presented, which states that the risk adjustment could include such an adjustment. Discussions of the Transition Resource Group (TRG) of the International Accounting Standards Board indicated that this alternative view is not supported. Reinsurer non-performance risk affects the present value of estimates of future cash flows of the group of reinsurance contract held and not the risk adjustment for non-financial risk of the group of reinsurance contracts held.

Chapter 11 – Business Combinations and Portfolio Transfers

24. Q 11.3 – What are the general requirements for determining if a transaction is a business combination?

The answer gives an outdated definition of business (taken from an earlier version of IFRS 3). The definition of a business per IFRS 3, effective 2020 and later, is: "An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities."

25. Q 11.6 – What are the requirements of IFRS 17 for insurance contracts acquired in a business combination or in a transfer of contracts that do not form a business?

The answer states: "… Hence, any positive difference between the fair value and the fulfillment cash flows of claims liabilities acquired in a business combination or in another transfer is deferred and released into income over the coverage period (i.e., **the period over which the acquirer is obligated to settle the claims**)." (Emphasis added.)

Per IFRS 17 paragraph B5: "Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain. An example is an insurance contract that provides insurance coverage against an adverse development of an event that has already occurred. In such contracts, **the insured event is the determination of the ultimate cost of those claims**." (Emphasis added.)

Hence, the coverage period and the period of time over which the CSM is released for such contracts extends to the period of time until the financial effect of the claims is certain. If the date of certainty of the amount is achieved prior to the date of actual claim payments, then the coverage period would end before claims are settled and paid.

26. Appendix to Chapter 11 (Business Combinations and Portfolio Transfers)

What is the guidance in IFRS 3 for recognizing and measuring identifiable assets acquired and liabilities assumed in a business combination?

This appendix includes additional information about IFRS 3 which is intended to be helpful. However, this appendix was based on an outdated version of IFRS 3. The latest version of IFRS 3 was updated in 2021 (IFRS - IFRS 3 Business Combinations).

What are some examples of intangible assets arising from a business combination involving contracts in the scope of IFRS 17, and what are the accounting requirements?

The list provided in this answer includes "value of liability guarantees."

The "value of liability guarantees" is not an example of an intangible asset. Rather, the market's view of the cost of providing such guarantees is included directly in the IFRS 17 fulfilment cash flows.

Chapter 12 – Transition

27. Q 12.22 – What transition requirements are different for groups of contracts measured using the premium allocation approach?

The first sentence states that "For the liability for remaining coverage, there is no risk adjustment or CSM or loss component to be determined at transition."

While this is normally expected to be the case, members should note that if facts and circumstances indicate that the group is onerous, there would be a risk adjustment (though no need to identify it separately) and a loss component.

28. Q 12.36 – How is the CSM or loss component measured at transition date under the modified retro approach?

The answer provides a list of modifications that may be permitted, which includes that "loss recovery components may be included under the modified approach if better information is not available". This conflicts with the answer to Q12.37, which states that the entity shall not identify a loss recovery component for the group of reinsurance contracts held, in the absence of reasonable and supportable information.

The answer provided in Q 12.37 covers the measurement of the loss recovery component for reinsurance contracts held at transition.

29. Q 12.37 – When should a loss component for reinsurance held be determined?

The question should read "When should a loss-**recovery** component for reinsurance contracts held be determined?".

Chapter 15 – Introduction and Explanation of Key Terms Relevant to the Financial Reporting of (Re)insurance Contracts Issued and Reinsurance Contracts Held

30. Q 15.1 – What is meant by the term "presentation" in an IFRS 17 context?

The answer to this question refers to paragraph 10 of IAS 1, which defines what a complete set of financial statements comprises.

However, the answer provided is incomplete, because it does not also reference the Notes to the Financial Statements, which (per IAS 1, paragraph 10) is a key component of the financial statements.

This is an important clarification, as it is relevant in defining the minimum requirements for "interim financial statements" in the context of paragraph B137.

Chapter 16 – Presentation Requirements Outlined in IFRS 17 Insurance Contracts

31. Q 16.11 – How should an entity treat exchange differences on changes in the carrying amount of groups of insurance contracts?

The answer states that "The entity should include exchange differences on changes in the carrying amount of groups of insurance contracts in the P&L, unless they relate to changes in the carrying amount included in OCI, in which case they should be included in OCI (paragraph 92)."

For clarity, exchange differences can also affect the CSM (per paragraphs 44d and 45d).

Chapter 17 – Disclosure Requirements Under IFRS 17 Insurance Contracts

32. Q 17.29 – What information about claims development must be disclosed?

The answer to this question refers to paragraph 130 which states the requirement to disclose of claims development over a ten-year period.

However, as a transition measure per paragraph C28, an entity need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the annual reporting period in which it first applies IFRS 17. However, it an entity does not disclose that information, it shall disclose that fact.

Table of Contents

Introduction

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

This IAN is based on the standard issued in May 2017 and the amendments published in June 2020. It also reflects some of the discussions held at the Transition Resource Group (TRG) meetings held in 2018 and 2019. This document will be revised in the future to reflect any future changes to the standard by IASB.

What are International Financial Reporting Standards?

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

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

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

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

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

[3] PRE.15 and IAS 1.16.

What is IFRS 17– Accounting for Insurance Contracts?

The project to develop authoritative guidance for accounting for insurance contracts in IFRS reports began in 1997. After introducing an interim standard, IFRS 4, in 2002, applicable from 2004 onwards, which allowed a wide scope of accounting approaches to continue to be applied, IASB completed the project in 2017 by issuing IFRS 17 – Insurance Contracts. Following feedback and consultation the IASB published amendments in June 2020. IFRS 17 is to be applied for all periods commencing on or after 1 January 2023 at the latest.

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

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

Recognition follows typical accounting practice but, in some cases, permits the recognition of future premiums that do not represent a current enforceable right of the entity. For that purpose, IFRS 17 introduces a concept referred to as contract boundary (see Chapter 1) describing whether a future non-enforceable premium and corresponding obligations might be anticipated or not in the measurement of the contract.

How is the insurance contract measured?

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

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

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

short coverage period (typically not more than 12 months), known as the premium allocation approach (PAA). Entities may use the PAA if it is a reasonable approximation to the GMA regardless of duration. The PAA is similar to the unearned premium method in that the measurement of the liability for remaining coverage of short duration contracts might be simplified by distributing premiums over the coverage period in line with passage of time or in proportion to expected benefits. The PAA mainly applies to the part of the total measurement of the contract referred to as liability for remaining coverage, with the liability of incurred claims following the GMA; however, further simplifications for the liability for incurred claims are available under certain circumstances.

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

Reinsurance ceded contracts, referred to as reinsured contracts held in IFRS 17, are measured separately from the underlying ceded contract, with special guidance for the CSM.

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

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

Which specific disclosure and transition requirements are included in IFRS 17?

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

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

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

References to IFRS 17

In this IAN the use of the phrase "paragraph X" etc. is a reference to paragraphs in IFRS 17. Where paragraphs from other IASs/IFRSs are referenced (e.g., paragraph 28 of IFRS 13) then that international standard is stated.

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

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

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

In this IAN where the words "must" or "should" are used only as specific references to an explicit requirement of IFRS 17, not as guidance from the IAA.

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

The following comes from ISAP 1:

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

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

Proportionality

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

Illustrative Examples

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

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

Chapter 1 on Classification of Contracts and Contract Boundaries

This chapter considers approaches to the classification required by IFRS 17, including the identification of contracts, the scope of IFRS 17, and contract boundaries. It refers to other chapters in IAN 100 addressing further specific classifications.

Section A – The General Measurement Approach

Chapter 2 on Estimates of Future Cash Flows

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

Chapter 3 on Discount Rates

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

Chapter 4 on Risk Adjustment for Non-Financial Risks

This chapter considers the criteria for, and measurement of, the risk adjustment for non-financial risk required as part of the general measurement approach under IFRS 17 including the purpose and general requirements of the risk adjustment, what risks would typically be covered, and specific considerations in determining the risk adjustment. This note discusses how to reflect risk mitigation as risk mitigation in a pool, diversification, risk sharing, catastrophic and other infrequent events, qualitative risks considerations, use of different approaches by line of business, and general considerations in selecting and calibrating a risk adjustment approach. For detailed risk adjustment methods and how to apply them, reference

[4] *Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins*

[5] *Stochastic Modelling – Theory and Reality from an Actuarial Perspective* (actuaries.org)

is made to the IAA monograph on risk adjustments [6]. This chapter also covers high-level disclosure requirements including confidence level disclosure, and issues around allocation of risk adjustments to a lower level.

Chapter 5 on Level of Aggregation

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

Chapter 6 on Contractual Service Margin and Loss Component

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

Section B – Variations to the GMA

Chapter 7 on Premium Allocation Approach

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

Chapter 8 on Participation Features and Other Variable Cash Flows

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

Chapter 9 on Reinsurance

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

[6] *Risk Adjustments for Insurance Contracts under IFRS 17* (actuaries.org)

Section C – Uses of Fair Value Measurement in IFRS 17

Chapter 10 on Fair Value

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

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

Chapter 11 on Business Combinations and Portfolio Transfers

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

Chapter 12 on Transition

This chapter considers the one-time event of presenting statements applying IFRS 17 for the first time. It has four sections: an overview and then a section for each of the three transition methods described in IFRS 17 – the retrospective approach of IAS 8 and the alternative approaches introduced by IFRS 17, modified retrospective and fair value. The chapter has a sample timeline. It also references content from chapter 10 on fair value.

Section D – Other IFRS 17 Topics

Chapter 13 on Embedded Derivatives

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

Chapter 14 on Contract Modifications

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

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

It also discusses when and how contracts can be derecognised.

Section E – Measurement, Presentation and Disclosures

Chapters 15–17

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

Chapter 1 – Classification of Contracts

Before consulting this chapter, be sure to read the Introduction to this IAN, particularly the sections on References to IFRS 17, Materiality and Proportionality.

1 A. What does this chapter address?

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

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

Paragraphs 2-24, 34-35, 62, 72-74, Appendix A, paragraphs B3-B27, B31-32, B61, B64, C10, C21, and C23 provide guidance on this topic.

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

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

None

Scope of IFRS 17

1.1. Which contracts are covered under IFRS 17?

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

- Insurance contracts (including reinsurance contracts) an entity issues;
- Reinsurance contracts an entity holds; and
- Investment contracts with discretionary participation features an entity issues, provided the *entity also issues insurance contracts* [emphasis added].

The definition of an **insurance contract** is the same as under IFRS 4 and can be found in Appendix A of IFRS 17.

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

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

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

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

A financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:

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

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

(c) that are contractually based on:

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

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

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

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

As noted in 1.1 above, Appendix A of IFRS 17 defines an insurance contract in terms of acceptance of "*significant insurance risk*". **Insurance risk** is defined in Appendix A of IFRS 17 as "*risk, other than financial risk, transferred from the holder of the contract to the issuer*". Paragraphs B7–B16 provide guidance on what is insurance risk is when applying this definition.

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

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

An insured event is defined in Appendix A of IFRS 17 as "An uncertain future event covered by an insurance contract that creates insurance risk." Paragraphs B3–B5 provide guidance on what "an uncertain future event" is when applying this definition.

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

As per paragraphs B11-B15, the insurance risk must have an adverse effect on the policyholder and is transferred to the insurer by the insurance contract. Therefore, the policyholder should already be exposed to this risk before the insurance contract is created (see paragraph B11). For the reasons above, lapse, persistency, and contract expense risks arising from a contract are not insurance risks.

However, a contract issued to an entity to cover risks such as lapse, persistency, or contract expenses on that entity's existing portfolio is, according to paragraph B15, expected to meet the definition of an insurance contract for the issuer, while the client entity is the policyholder. Further, if the entity's existing portfolio includes insurance contracts, not just investment contracts, then such a contract also likely to qualify as reinsurance held for the policy holding entity. If there are no insurance policies in the portfolio, the contract does not fall under IFRS 17 for the entity.

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

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

1.3. What is the definition of significant insurance risk?

An insurance contract is only in scope of IFRS 17 if it transfers a significant amount of insurance risk to the entity (or reinsurer).

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

Insurance risk can already be significant even if the policyholder still has to opt for insurance cover in the future, if the insurer has no practical ability to set a price on the cover that fully reflects the risk of the contract. Also, an insurance contract remains an insurance contract even if the original insurance risk has expired, unless a specified contract modification has occurred (see paragraphs 72 and 74–77).

IFRS 17 requires that the compensation and its commercial substance be considered on a present value basis.

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

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

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

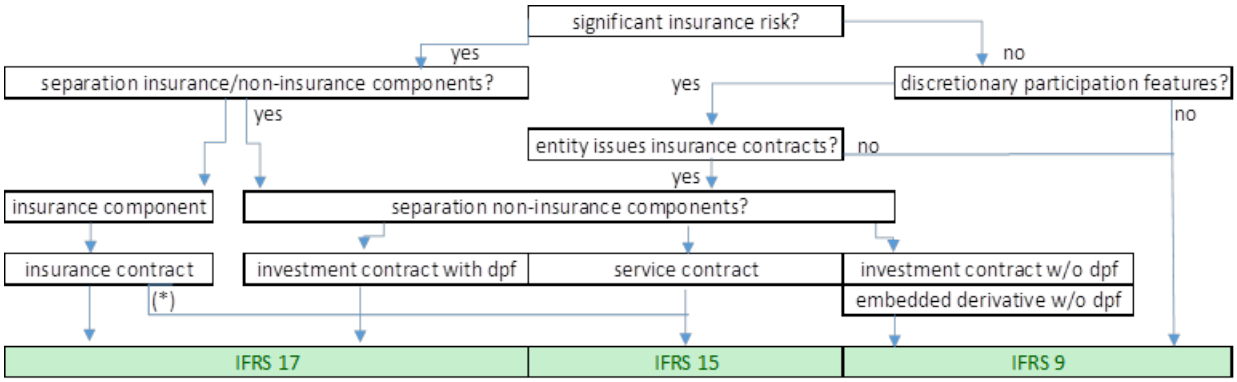
Paragraph 7 sets out contracts that are specifically excluded from the scope of IFRS 17 even if they meet the definition of an insurance contract. This list is similar to the one in IFRS 4; however, IFRS 17 now explicitly excludes residual value guarantees provided by a manufacturer, dealer, or retailer.

In addition, under paragraph 7(e), although financial guarantee contracts remain excluded from the scope of IFRS 17, an entity that has previously regarded such contracts as insurance contracts and applied insurance accounting on them, now has the option to

use IFRS 17 for such contracts. Otherwise, the IFRSs relating to financial instruments apply (IFRS 7, 9 and 32).

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

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



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

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

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

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

a) The entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;

b) The contract compensates the customer by providing services, rather than by making cash payments to the customer; and

c) The insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services.

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

1.6. Where does the scope of IFRS 17 differ from IFRS 4?

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

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

Separation of components from a contract

1.7. When might components of a contract be accounted for separately?

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

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

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

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

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

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

1.8. What are examples of components that are often separated, but cannot be separated under IFRS 17?

Some contract components may now be administered and/or reported separately but cannot be qualified as “distinct”. In these cases, IFRS 17 requires that the contract components are not separated from the insurance contract.

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

Contract boundary

The contract boundary distinguishes expected future cash flows to be considered in the measurement of the insurance contract from other future cash flows, even if these are also expected to be. The contract boundary determines where a contract ends for measurement purposes for a certain reporting period.

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

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

> *"Cash flows are within the boundary of a contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums, or in which the entity has a substantive obligation to provide the policyholder with insurance contract services."*

Paragraph 71 does the same for investment contracts with discretionary participation features.

In June 2020, the Board amended the definition of a coverage [period to be the period during which the entity provides insurance contract services (see paragraphs BC283A-BC283J).

1.10. What are "substantive rights and obligations"?

Paragraph 2 makes it clear whereas *rights and obligations arise from contract, law, regulation or customary business practices, the enforceability of rights and obligations is a matter of law*.

IFRS 17 applies the term "substantive" to identify when future cash flows arising from those rights and obligations can be recognised as assets or liabilities. Accordingly, all clear cases of present enforceable rights or present enforceable obligations, as discussed in paragraph BC160 are within the contract boundary if they are substantive. Any terms that have no economic substance are disregarded.

According to paragraph 34, "cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with insurance contract services".

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

If the policyholder cannot be forced to pay the premium (e.g., if the policyholder is not obliged to renew a contract and the entity can refuse to renew a contract with an agreed duration), then any premiums after the agreed duration are not within the contract boundary.

A possible indication of a substantive obligation could be when the applicable terms and conditions can cause future cash flows to become onerous without the insurer having the ability to avoid such losses due to the absence of any cancellation or premium or benefit adjustment right. Typically, such situation would then also be reflected in the risk adjustment.

For example, in the case of a contractual clause that the funds of the contract might be used to purchase an annuity where the assumptions regarding longevity could be adjusted to represent the individual longevity risk but not beyond that, the annuity is normally not within the contract boundary because there is an element of repricing. If the terms and conditions determine a contractually fixed annuitization rate, however, then the entity is likely to be subject to a substantive obligation, and the loss-making annuitization of the funds might be anticipated considering the likelihood that the annuity will be elected.

This might also apply in cases where a premium component, with a unilateral right of the policyholder to pay the premium in future, includes minimum financial guarantees that are in the money at the reporting date and the adjustment clauses would not allow the entity to avoid that loss if the policyholder decides to pay the premium.

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

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

b) Both of the following conditions are satisfied:

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

   ii) The pricing of the premiums up to the date when the risks are reassessed does not take into account the risks that relate to future periods.

Further guidance on finding the appropriate contract boundary could be derived from the March 2018 IFRS Conceptual Framework. Paragraph 4.51 of the Conceptual Framework makes the link between the contract as the unit of account and the provision of useful and relevant information to stakeholders. Specifically,

- 4.51(a) of the Conceptual Framework makes references to the expiration pattern and interdependency of future cash flows. Also, the general expectation is that entities usually design contracts in a way that reflects their substance (see AP01 paper to May 2018 TRG).
- 4.52 of the Conceptual Framework points out the importance of considering if the benefits of a certain unit of account justify the costs of providing information at that level.

1.11. What does it mean to not have the practical ability to reassess the risk?

The reference to the "practical ability" to reassess the risk is intended to differentiate from a pure formal legal right to do so, but where practical facts and circumstances prevent the entity from doing so.

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

Paragraph B64 notes that practicable ability exists if the entity can reprice the contract or portfolio (as applicable) to the same price it would charge for a new contract or portfolio with same characteristics. If an entity decides to charge a new price for new contracts, but for commercial reasons decides not to do so for existing contracts, then further judgment is required to assess whether this commercial decision was a free choice or refers to a practical inability to reprice. (see paper AP03 to May 2018 TRG.)

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

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

The conditions outlined here might only be understood by considering the underlying risk for the "particular policyholder" and cannot be assessed based on collective information. Therefore, under paragraph 34 (a), this can be interpreted to refer to risks transferred from the policyholder, insurance and financial risk, only.

Paragraph 34 states that the reassessment should be able to *fully* reflect these risks, which in B64 is explained as all of the above risks.

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

Reassessment is more than the ability to reflect changes in the general market view on risks; it requires the ability to reflect the perceived risks of the portfolio itself.

Again, the risks being reassessed are policyholder risks transferred from the policyholder, insurance and financial risks, and not lapse and expense risks created by the contract, even though they would be reflected in pricing (see paper AP02 to February 2018 TRG).

For reinsurance contracts, however, lapse risk and expense risk may be risks that are transferred from the insurer to the reinsurer (paragraph B15). Thus, for reinsurance, these risks are also subject to the reassessment of risk.

1.14. When do premiums take into account risks that relate to future periods?

The condition in paragraph 34(b) refers to substantive obligations arising from premiums already paid in the past even in the case of a collective premium or benefit adjustment

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

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

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

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

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

This situation occurs if the future benefits are to be provided in the form of another service, e.g., an investment contract with an option to purchase an annuity with proceeds at maturity (see paragraph B24).

The answer is that in that case, the measurement at the execution date of the option (i.e., the date of the contract boundary) assumes that the available value for transfer subject to the pricing decision is assumed to be paid in cash.

1.16. What are the points of attention for contract boundaries under reinsurance?

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

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

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

- A new reinsurance contract may cover insurance contracts that existed prior to the reinsurance contract coming into effect; or

- The scope of the reinsurance contract may extend to include future insurance contracts yet to be issued within the boundary of the reinsurance contract.

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

Also, reinsurance contracts sometimes provide the reinsurer with cancellation options that are more flexible than in direct insurance, and thus care is needed in assessing the boundary of a reinsurance contract held because it can be different from the boundaries of the underlying reinsured contracts.

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

Paragraph 35 states that expected future cash flows that are not within the contract boundary relate to future contracts. IFRS 17 does not make a distinction between the situation where such cash flows are highly interrelated with the existing contract or not.

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

Future insurance contracts

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

This has significant implications if the cash flows resulting from paid and future premiums are highly interrelated, as discussed in the next paragraph.

Acquisition expenses for the contract as a whole: acquisition expenses are allocated to the initial contract created by premiums paid up to annual renewal, except to the extent they are dependent on renewal of the contract (e.g., acquisition commission subject to clawback if the contract is not renewed can be allocated to the future contract created by the renewal (see AP04 February 2018 TRG)). This may lead to an onerous “first” contract comprising the first premium only and to several very profitable contracts related to future premiums afterwards.

In some instances, a rider cost may be funded from an investment component built by paid premiums. The risk premiums extracted from each “premium layer” contract would be reconsidered every time a new premium is paid.

Also, it may be technically possible that such "new" contracts are not in the scope of IFRS 17, e.g., right to insurance cover is not available in later years of the contract. As discussed in questions 1.10, 1.12, and 1.15 of this chapter, the current contract and such future new contracts would, in principle, have unrelated cash flow patterns that are not interdependent.

Paragraph 25 requires that a "new" contract (e.g., a future premium that is now outside the contract boundary) is recognised at the earliest of:

(i) The beginning of coverage period;

(ii) The date of the first payment; and

(iii) The moment that the contract becomes onerous.

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

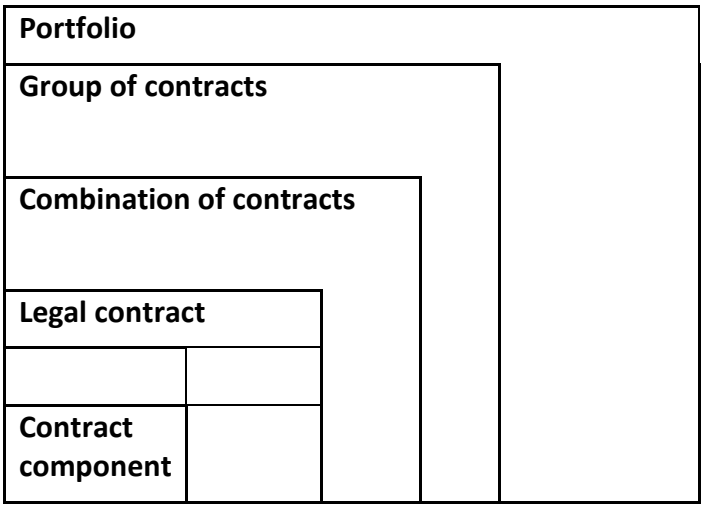
1.18. When should a contract boundary be reassessed?

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

It might be argued, in the example of future premiums being outside the current boundary of a contract, that any new premium paid could be seen as "crossing" the existing boundary and extending the new boundary by including the newly received premium and all related cash flows[7].

Aggregated levels of insurance contracts

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



In this section, the levels above contract level are discussed.

[7] This was discussed during the September 2018 TRG.

1.19. When should contracts be combined for measurement purposes?

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

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

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

This is not to be confused with a legal contract that has multiple insurance components. Such contract must be considered as a whole, even if the insurance components can be measured separately. Paragraphs 10-13 do not require that such a contract should be split in different sub-contracts.

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

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

Also, insurance contracts and investment contracts with discretionary participation features can be in the same portfolio when they are managed together. This would be the case when some contracts, but not all, have active insurance covers. This situation is why contracts with discretionary participation features are in scope of IFRS 17, but only for entities that also issue insurance contracts (paragraph BC83).

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

In general, IFRS 17 and its Basis for Conclusions contain several sections related to this question. Paragraph 14 states:

> A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.

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

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

1.22. What does "managed together" mean?

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

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

It is possible that the determination of the portfolio level will vary between entities due to different sizes and complexity as well as the different ways in which business is managed. A practical approach to determining the portfolios for an entity might rely on the internal management reporting systems. For example, an entity's internal management systems may consolidate results into product lines. These product lines could provide a suitable aggregation of similar risks; furthermore, an entity may have its systems aligned with its internal management structure and may disclose to the market on that basis. This might be sufficient but not necessary to assume that the business is "managed together".

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

- Distribution channel(s) that the contracts are sold through;
- The level at which regulation takes place (e.g., compulsory third-party insurance in Australia);
- Capital allocation basis;
- The operating model or management structure of the entity, including how management incentives are structured;
- The way contracts are reported together in performance reports; and
- The way in which investments and asset liability risks are managed.

Product line groupings as prescribed by prudential regulators may not necessarily be appropriate to define portfolios due to a different focus in IFRS 17. The latter's primary

focus is about reporting appropriate profits and losses (paragraph BC119) rather than the solvency focus of prudential regulators.

Note that an entity may change how it manages its business over time. As a result, the number and/or the composition of portfolios may change over time; although it does not necessarily affect the number of groups, as historical groups do not change and are sub-sets of the portfolios.

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

The definition of portfolio has an impact on:

- Further grouping of contracts, which can only be done within a portfolio;
- The level at which entities can make an accounting policy choice to reflect all insurance finance income or expenses in profit or loss or disaggregate it between profit or loss and other comprehensive income. This comes from the fact that IFRS 17 assumes that each portfolio has its own portfolio of assets backing the insurance contracts (see paragraphs BC42–BC44).
- The level at which an entity would consider its ability to reassess risks in order to define contract boundaries (see paragraph 34(b)(i)).
- Expenses included in measurement, as expenses need to be directly attributable at portfolio level (see paragraphs B65(e) and B66(d)).

It is important to remember, however, that the significance of insurance risk is considered at the portfolio level but still in relation to individual contracts (see paragraphs B22 and BC79).

Groups of contracts

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

Please see Chapter 5 – Level of Aggregation.

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

Please see Chapter 2 – Estimates of Future Cash Flows.

Section A – Introduction to the General Measurement Approach

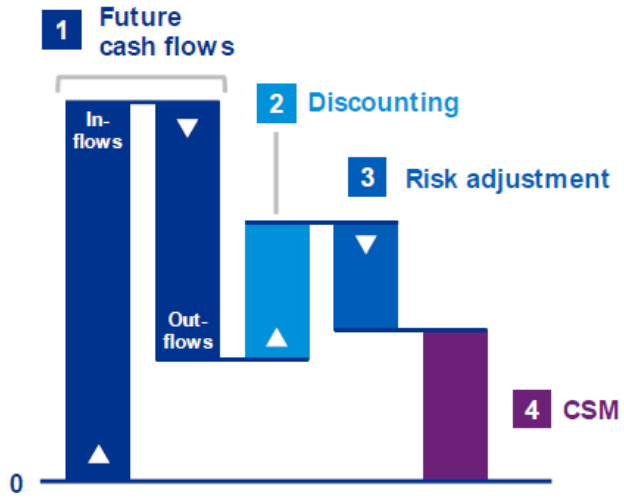
This section includes five chapters that cover the technical aspects of the general measurement approach (GMA).

These areas are:

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

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

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



Note: thanks to KPMG for this representation

1 Unbiased estimate of future cash flows

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

2 Discounted to balance date

At a rate not dependent on the assets supporting the liabilities items (based on either the "bottom up" or "top down" approach) for most contracts, the discount rate reflects the characteristics of the insurance liability and is consistent with relevant observable market inputs for each reporting period.

3 Add risk adjustment

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

4 Allow for profit/loss effect

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

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

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

The IAA has published a paper on Current Estimates (Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins[8]) – see, in particular, chapter 2, and monographs on Discount Rates[9] (see chapter 3) and on Stochastic Modeling[10] that may be useful for this

[8] Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins
[9] Discount Rates in Financial Reporting (actuaries.org)
[10] Stochastic Modelling – Theory and Reality from an Actuarial Perspective (actuaries.org)

purpose. More recently, a monograph on Risk Adjustment[11] was released in May 2018 (see chapter 4). In general, we do not repeat material from any of the monographs in this IAN. In addition, the general educational material of IAA members provides significant educational material on the different ways to estimate future cash flows. All of this educational material may be relevant.

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

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

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

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

b) In defining an adjustment for the ***"time value of money"***, IFRS 17 incorporates the need to allow for "the financial risks associated with the future cash flows" (paragraph BC 19), hence arriving at a risk-adjusted rate of discount. However, it also recognises that certain insurance contracts may combine financial and non-financial risks in such a way that "those components are interrelated" (BC 18). Hence, there is potential for the adjustment for the time value of money to exclude financial risk adjustment.

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

[11] Risk Adjustments for Insurance Contracts under IFRS 17 (actuaries.org)

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

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

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

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

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

It should also be noted that actuarial input is far from limited to the balance sheet perspective with regards to IFRS 17. As is referenced in Section E – Presentation and Disclosure.

Chapter 2 – Estimates of Future Cash Flows

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

2.A. What does this chapter address?

This chapter provides information concerning the estimates of future cash flows for use in measurement of liabilities and assets arising under contracts within the scope of IFRS 17. This applies both at issue of the contract and at subsequent measurements. Cash flows in this chapter are undiscounted unless otherwise stated.

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

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

Paragraphs BC 146–BC184 also provide background on the subject.

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

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

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

General Issues:

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

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

i. Include all future cash flows within the contract boundary, including those that may have been previously accounted for separately from the insurance contract liability (e.g., overdue premiums);

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

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

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

v. Are current; and

vi. Are explicit.

In estimating future cash flows, it may be necessary to reflect the specifics of the entity for which the cash flows are being estimated. For example, different entities may have different underwriting or claim settlement practices that might affect the estimated future cash flows. While past experience may reflect the practices in effect at the time, if the entity has made changes to those practices, assumptions based on past experience may need to be adjusted for the changes.

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

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

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

Paragraph B65 states:

"*Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing.*"

These cash flows include, but are not limited to:

- Premiums, including overdue premiums;
- Payments to (or on behalf of) policyholders including
    - Claims that have been reported but not yet paid;
    - Incurred claims that have not yet been reported;
    - Payments that depend on returns of underlying items (see Chapter 8 – Contracts with Participation Features and Other Variable Cash Flows);
    - Payments to third parties in fulfilling obligations to (or on behalf of) the policyholder (e.g., in third-party liability insurance or participating benefits where the contract grants the entity discretion to whom surplus is distributed);
    - Payments from embedded derivatives if not separated;
- Payments on future claims on unexpired risks;

- An allocation of insurance acquisition cash flows;
- Claim handling costs;
- Costs the entity will incur for payments in kind;
- Policy administration and maintenance costs;
- Transaction-based costs such as premium taxes and levies;
- Income taxes either paid in a fiduciary capacity to meet obligations of the policyholder or specifically chargeable to the policyholder;
- Cash inflows from salvage, subrogation, and other recoveries;
- Retrospective premium adjustments based on claim experience within the contract boundary (e.g., some workers compensation and reinsurance contracts);
- An allocation of fixed and variable overheads directly attributable to fulfilling insurance contracts; and
- Any other costs specifically chargeable to the policyholder under the terms of the contract (e.g., fees contractually agreed for printing a new policy document after loss of the original one).

2.3. At what level are cash flows determined?

Cash flows can usually be identified at the individual contract level. For measurement purposes, however, contracts are aggregated into portfolios of insurance contracts ("portfolios") and groups of insurance contracts ("groups") (see Chapter 5 – Level of Aggregation). IFRS 17 allows the entity to estimate the cash flows at whatever level of aggregation is most practical. If the entity makes estimates at a higher level, it needs to be able to allocate or apportion those estimates to groups so that the appropriate amounts are included in the measurement of the groups' fulfilment cash flows for remaining coverage and incurred claims.

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

In some situations, particularly for contracts covering multiple risks and/or perils, it may be helpful to analyse the experience separately for each of the multiple coverages. Such separation, for analysis and projection purposes, is particularly appropriate where the balance of coverages varies from contract to contract within a line of business (e.g., small business package policies). Such coverage cash flows may then be combined at the contract level if practical and useful, before contract cash flows are aggregated into groups for measurement purposes. Similar concerns will also apply to life insurance

contracts with multiple risks (e.g., mortality and disability) or groups with multiple durations (e.g., 10, 20, and 30-year term in the same group).

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

Issues concerning the definition of cash flows to be included

2.4. What is a current estimate?

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

IFRS 17 defines the term "fulfilment cash flows" as including the risk adjustment for non-financial risk (herein shortened to "risk adjustment") and the effect of discounting. This chapter, however, does not refer to issues regarding calculating present values nor the risk adjustment but focuses on the identification of cash flows and estimating unbiased expected values of those cash flows.

2.5. What is the meaning of expected value?

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

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

The reference in IFRS 17 to scenarios is about the defining characteristic of the mean value of a distribution function rather than providing guidance regarding how to estimate the expected value. IFRS 17 does not require that all possible (or even any) scenarios be

explicitly constructed nor is it expected that entities will develop stochastic models for all IFRS 17 reporting.

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

The distribution function of cash flows does not necessarily need to be determined. The accounting purpose is to derive a current unbiased estimate of the expected value of cash flows. There are a variety of approaches that can be used for this purpose, and IFRS 17 does not provide any guidance regarding how the estimate is to be made. Any statistical or non-statistical approach applied in determining figures for an IFRS report needs to comply with general accounting requirements as outlined elsewhere in this chapter.

2.7. What does "unbiased" mean?

According to paragraphs BC 148 and BC 149, unbiased estimates:

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

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

c) Should not have an intention of influencing a particular behaviour.

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

2.8. How does the objective for current estimates under IFRS 17 differ from objectives for other purposes?

IFRS 17 calls for an estimate of the statistical mean rather than the statistical median or mode. Other descriptions, such as best estimate or best estimate plus a margin, used in other accounting structures, may differ from the IFRS 17 objective. Before using cash flows developed for other purposes, their fitness for reporting under IFRS 17 would need to be assessed.

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

Paragraph B65 sets out the cash flows included in the measurement of insurance contracts and paragraph B66 sets out those that are excluded. Broadly, cash flows are included if they are specifically generated because the contract is in existence (e.g., benefits, commissions, and direct administrative expense) and needed in fulfilling the contract. Indirect administrative expenses, including general overhead, are included only to the extent that they are directly attributable to fulfilling a portfolio as per paragraph B65(l). If such expenses are not directly attributable, they are general expenses of the entity not belonging to the contract and are thus not considered in estimates of future cash flows of the contracts.

Paragraph B66 excludes cash flows that are covered elsewhere such as investment returns, reinsurance, separated components valued under other standards, cash flows beyond the boundary of the contract or not directly attributable, and taxes not included under B65(i), wastage and internal transfers that do not affect policyholder benefits.

Investment administration costs are excluded except if they are costs for (B65(ka)):

- Investment activities that enhance benefits from insurance coverage;
- Providing investment-return service under non-participating contracts;
- Providing investment-related service under participating contracts.

Also, any other costs explicitly charged under the terms of the contract (b65(m)).

Whether a particular outflow (or inflow) is included will likely depend on the specifics of a situation and the terms of the insurance contract.

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

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

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

For the purposes of initial grouping, an entity may identify the fulfilment cash flows of an individual contract. Accordingly, assumptions that are appropriate for that purpose would need to be chosen for each contract. It is necessary to determine the degree to which the assumptions are differentiated for the characteristics of individual contracts. The individual characteristics of each contract are only considered to the extent that the impact is relevant to the purpose of the initial grouping.

It may be desirable to consider, in an internal experience analysis, a wide range of factors which might be used for determining liability for remaining coverage and liability for incurred claims, in order to determine whether it is appropriate to incorporate such factors explicitly into the analysis and whether it is appropriate to then incorporate them into the measurement. Factors need not be incorporated in the analysis unless there is reason to expect that they can reasonably be collected and used by the entity without undue cost and that they are likely to materially impact the measurement of the fulfilment cash flows of the groups.

Many characteristics of contracts will not be available to the entity in any case. For other characteristics, even if known, the entity might not be able to assess their impact due to limited statistical data or the undue cost or effort to obtain them. Other characteristics of contracts will not be consistently available for all contracts and, as a consequence, may be averaged over other contracts. Other characteristics, which might be assessable at outset or even are assessed, might be ignored in pricing, because the overall benefits from such

a differentiation would not outweigh the cost of doing so. For example, certain medical examinations or adjusting information systems to differentiate a certain characteristic could be more expensive than the price effect. An entity might thus limit the differentiation of contract characteristics to a certain number that can be administratively and statistically managed in a reasonable way.

Accordingly, for estimating the liability for remaining coverage, the differentiation of assumptions as applied to individual contracts might start with the differentiation used for pricing. Less differentiation than applied in pricing might, if applied to individual contracts, result in inconsistencies between premiums and the measurement of the related cash outflows if the cash flows are based on averaged assumptions while the associated premiums are more differentiated. For example, a contract viewed in pricing as being riskier and accordingly having a higher premium when compared with an average risk might show a high contractual service margin (CSM) unless offset by a higher risk adjustment, while a contract seen in pricing as less risky and accordingly having a lower premium in comparison with the average risk might result in a low CSM or even show a contract as onerous. For this reason, particularly in non-life insurance, the premiums charged are sometimes used as a proxy for other differences between contracts.

There are exceptions to this principle. Paragraph BC135(a) refers to an "intentional pricing strategy". If an entity intentionally under-prices certain contracts, for example, to gain market share by ignoring relevant and known characteristics of the contracts, it, in effect, charges insufficient premiums for those contracts, even if the premiums for the portfolio as a whole are sufficient. Unless the entity is required by law to ignore these characteristics, IFRS 17 requires the entity to allow for them in measurement and, if it so turns out, recognise a group of onerous contracts.

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

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

Inflows

2.11. What are the cash inflows to be considered?

All cash inflows arising under rights of the insurance contracts and directly related to services provided within the contract boundary are considered. The primary inflow is, of course, premium. Investment income, other than that related to policy loans (see question 2.12), is not included, because it is a cash inflow due to investments and not specifically related to the fulfilment of the contracts.

Other cash inflows considered include such items as salvage, subrogation, contract charges such as cost of insurance charges, and claw-backs of agent commissions originally paid related to the contract. The treatment of such recoveries is not specified in IFRS 17. Also not specified is the treatment of retrospective premium adjustments based on claim experience. Any discrepancies between actuarial estimates of these recoveries and their accounting treatment (as, possibly inflows or negative outflows) could give rise to double counting or omission. Cash inflows on insurance riders and future insurance options, such as disability premium waiver, hospitalisation, term insurance, guaranteed future insurance (including cash flows from the expected exercise of such guarantees) will also be included, if they are related to services provided within the contract boundary. See Chapter 1 for more on contract boundaries.

Waiver of premium benefits are usually treated as a cash outflow equivalent (i.e., claim benefit) provided to the policyholder. They are treated accordingly when determining the liability for remaining coverage and liability for incurred claims (when premium is being waived).

Cash flows relating to reinsurance held premiums and related expenses (outflows from the entity's perspective) and claims recoveries and commissions (inflows from the insurer's perspective) are also estimated but are included in the future cash flows of the reinsurance contract held rather than the underlying insurance contract (see Chapter 9 – Reinsurance).

2.12. How are policy loans and repayments handled?

If policy loans are a component of the insurance contract (i.e., they are legally part of the insurance contract), loans and repayments of policy loans are part of fulfilment cash flows, although the payment itself does not represent an insurance contract service. If future policy loans are expected within the contract boundary, expected future loans and repayments as well as interest accrued on outstanding loans are also a part of the fulfilment cash flows.

2.13. How are premiums prepaid with interest accretion treated?

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

is considered in measurement and treated as an adjustment to premium as per paragraph B65(a).

IFRS 17 does not directly address the issue of recognition of prepaid premiums but does require that liabilities reflect paid premiums not premiums due. In the same way that insurance acquisition cash flows arising before recognising the group are an asset according to paragraph 27, liabilities arising from prepaid premiums might, but not necessarily, be recognised as a liability (that would be reported with insurance contract liabilities) until initial recognition of the related insurance contract.

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

Extra premiums for substandard risks are treated identically to other premiums. Moreover, to be consistent with the extra premiums, it is important that expectations for the related future benefits are estimated on the basis of the correspondingly higher risk. Actuaries might also consider whether the statistical knowledge available about the higher risk provides an adequate basis from which to develop an appropriate estimate that deviates from the extra premium determined. See paragraph 2.10 for further discussion of the treatment of different underlying assumptions. Similar considerations apply for premium rebates for risks better than standard.

Outflows

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

Benefit or claim payments, directly related expenses, and similar items are the important items included in cash outflows. As noted previously in question 2.11, the treatment of salvage, subrogation, and retrospective premium adjustments based on claim experience is not specified in IFRS 17. Any discrepancies between actuarial estimates of such recoveries and their accounting treatment (as, possibly outflows or negative inflows) could give rise to double counting or omission of these cash flows.

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

Paragraph B41 requires assumptions to be based on information including, importantly, the entity's own experience to the extent it is available, supportable, and credible. The results arising from an entity's data may need to be adjusted if there is reason to believe that historical patterns and/or relationships will not continue in the future or if other influences may affect them. If internal data are not available, either in whole or in part, then industry or other available data, e.g., population data, may need to be used as a basis for assumptions. In general, an entity's experience will be analysed for this purpose using an internal experience study.

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

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

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

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

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

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

The basis for the expected value is the entity's estimate of future expected behaviour (based on experience and judgement), not necessarily financially rational behaviour (see paragraph B62). Experience might cover only a very limited range of circumstances as incurred up to the present. Accordingly, for a wide variety of possible future circumstances, no past experience may be available. In filling that gap, it may be appropriate to consider whether the chosen assumptions have a significant effect on the outcome compared with the outcome resulting from assuming that the behaviour would be in line with past experience even in changed circumstances. If the difference is relevant, it may be appropriate to consider if and how the experience needs to be adjusted to reflect expected future conditions (paragraph B41(c)). The risk of departure from such assumptions is to be considered in the risk adjustment to the extent it is non-financial risk. The expected value considers both advantageous and disadvantageous behaviour of policyholders.

One of the considerations when setting assumptions is the possible effects of policyholder anti-selection. In certain circumstances, policyholder behaviour will depend on financial circumstances; in such situations, it may be important that the policyholder behaviour

assumptions be consistent with the financial assumptions being used. This applies whether or not a stochastic approach is used.

Internal Costs

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

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

Future costs will also consider whether the entity is being measured as a going concern. If so, costs may need to reflect a reasonable development of future new business, if appropriate, in deriving an unbiased estimate of the mean, representing any expected economies of scale.

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

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

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

The key guidance for differentiating cash flows other than claims payments and other contractual services is the exclusion of general overhead costs in paragraph B66(d) if they "*cannot be directly attributed to the portfolio of insurance contracts that contain the contract*". On the other hand, paragraph B65(l) includes examples of some overhead expenses that are included in estimated future cash flows. Those general overhead costs that are not included in the estimate of future cash flows are accordingly subject to authoritative guidance in other IFRSs determining their recognition, measurement, presentation, and disclosures. This IAN does not discuss such items.

The reference to "*directly attributable*" is a generally used phrase in IFRSs, and the entity might have previously adopted interpretations of this term in its accounting policies. This IAN does not discuss the accounting meaning of this phrase. The accounting interpretation of this phrase might, however, result in the need to choose the partition of the business into portfolios suitably to allow an adequate split of currently incurred and future expected costs between those "*directly attributable*" to a portfolio and general overhead that is not considered in measurement and presentation of insurance contracts. This is a potentially disputable situation, and there are several possible ways of resolving the situation.

After identifying those internal costs that are considered in the measurement of insurance contracts, those costs might be differentiated regarding their function in fulfilling the insurance contracts. IFRS 17 distinguishes insurance acquisition cash flows from other internal costs. A further differentiation might arise in separating costs needed for the settlement of claims, which are considered in the insurance liability both in the liability for incurred claims and for remaining coverage. IFRS 17 is silent regarding how to accomplish this separation, which might be seen as an indication that normal cost accounting approaches, particularly allocations between functions, are appropriate.

In summary, the identification of costs, as estimated by the entity for future periods, considered in measurement might be split in three separate steps:

1) Exclude estimated costs that do not relate directly to the fulfilment of the contracts (paragraph B65).

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

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

Actual incurred costs are split between insurance service expenses, insurance acquisition cash flows, and other costs presented outside the insurance service result.

2.23. What are insurance acquisition cash flows?

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

To identify insurance acquisition cash flows within the contract boundary, it might be of relevance to consider the trigger of the cash flow. If a payment is contingent on persistency beyond the contract boundary, it might be seen as an insurance acquisition cash flow outside the contract boundary. Therefore, those costs are not included in the cash flows of the existing contract. In that case, the item is recognised in measurement only when the new contract is recognised. If the payment is contingent only on persistency within the contract boundary, it is generally considered an administration cost.

2.24. When are insurance acquisition costs established as an asset?

Whenever the insurance acquisition cost is incurred in a reporting period before the reporting period in which the contract or group of contracts (to which the acquisition cost is allocated) is recognised. Paragraph 28A requires an entity to allocate acquisition cash flows directly attributable to a group of insurance contracts between that group and to future groups expected to arise from renewals of those contracts. In most cases, this will only apply to short duration contracts, which are often measured on a PAA basis.

2.25. How are insurance acquisition cash flows that have been established as an asset recognised and derecognised over time?

Paragraphs B35A-D give the methodology for recognising and derecognising these assets.

Assets are recognised when acquisition costs are incurred / paid and are derecognised over time as the insurance contracts that generate the costs are recognised. At a reporting date, there will only be assets related to contracts and groups that have not yet been recognised at the reporting date. Paragraph B35D requires impairment tests to ensure that the asset related to each group does not exceed the net future cash flows of the group, and that any assets allocated to future renewals under B35A(a)(ii) do not exceed the net future cash flows of those renewals.

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

Insurance acquisition cash flows paid prior to initial recognition are reflected as paid and recognised as an asset. It is allocated using a systematic and rational method to the starting group of insurance contract and to the groups that are expected to arise from its renewals. When the related insurance contract is added to a group the related portion of the insurance acquisition cash flows is derecognised. An allowed exception to this recognition and derecognition is for groups using the PAA and if each contract in the group has a coverage period at initial recognition of 12 months or less when insurance acquisition cash flows are recognised as expenses (59(a)).

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

Insurance acquisition cash flows incurred after the initial sale are reflected in the same way as other future costs regardless of the period in which they are paid. That is, they are included in the contract's estimated future cash flows on an expected value basis. For example, if the payment of the commission is dependent on the contract continuing within the contract boundary, the probability of lapsation is reflected. In this sense, the commission is considered to be directly attributable costs.

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

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

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

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

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

The following might not be considered insurance acquisition cash flows:

- Payments to managers of agencies or brokerages not based directly on sales;
- Payments to managers of agencies or brokerages based on policy persistency; and
- Premium and commission processing costs.

Other Cash Flow Issues

2.30. Are any taxes included in cash flows?

See paragraph B65. All transaction-based taxes (such as premium taxes, value added taxes, and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) are included in cash flows. Wage-based taxes, referred to as payroll taxes, social security taxes, and similar items are also included to the extent the wages they are based on are included. Any taxes paid on behalf of the policyholder are also included. If the impact of certain of these taxes is only the small difference of the time value of the incoming and outgoing cash flows, those impacts could usually be ignored based on materiality considerations but perhaps noted in disclosures.

Income taxes and other similar taxes levied on the entity are not included as a cash flow in contract measurement, even if they are reflected in benefits paid to policyholders, unless such taxes are paid in a fiduciary capacity on behalf of the policyholder or are specifically charged to the policyholder under the terms of the contract.

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

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

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

See Chapter 8 – Contracts with Participation Features and Other Variable Cash Flows.

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

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

2.34. How are costs related to disputes accounted for?

Expected future costs for settling known disputes are included in fulfilment cash flows. Specific possible future disputes not yet known are not explicitly considered, but a pattern of disputes, most notably litigation in the course of claim settlement, would be allowed for on an expected value basis.

2.35. How are interest credits paid to policyholders projected?

See Chapter 8 – Contracts with Participating Features and Other Variable Cash Flows.

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

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

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

The best available relevant experience, including related internal experience and available data from the industry, may be considered and supplemented by documented judgment.

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

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

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

If the perils are fully independent, then simple addition can be used; however, if the data for one peril is insufficient for a reliable estimate, then estimating cash flows by peril may be inadvisable.

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

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

Where an additional premium is to be negotiated when the extent of the insurance (e.g., lives in group life, health, or disability; wages in workers compensation; and underlying insurance in the case of reinsurance) is added to, estimates may be made on the basis of the extent of the insurance active at the measurement date, but in general only if the additional insurance is beyond the contract boundary before it is added.

More usually, if the entity is constrained to accept such additional insurance within the existing insurance, this brings it within the contract boundary, and an expected value approach is appropriate for estimating both the additional premium and the extent of the insurance that will be covered within the contract boundary.

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

Changes in estimates

2.40. How often are estimates re-evaluated?

Estimates must be re-evaluated at every reporting date (paragraph B54).

2.41. How often are assumptions re-evaluated?

In compliance with paragraphs 33(c) and B54-B60, assumptions must be re-evaluated at every reporting date.

- Assumptions for estimating market variables should be based on market prices at the reporting date.

- For other assumptions, continuity and consistency of process are usually appropriate and any discontinuities should be highlighted.
- Where claim assumptions are based, in whole or in part, on claim experience data, regard should be had to the credibility of that data, and the assumptions adjusted accordingly.
- Where standard tables are used, their continuing suitability should be considered, and adjustments made as appropriate. Small, frequent adjustments are preferable to big changes.
- Existing trend assumptions may need to be reviewed to assess whether current data support the assumed trend or suggest that it be revised.

Chapter 3 – Discount Rates

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

3.A. What does this chapter address?

This chapter discusses practices related to interest rates, yield curves, discounting and replicating portfolios for insurance contracts as required by IFRS 17. First the general principles for discounting within IFRS 17 are discussed in questions 3.1–3.10. Discount rates used for cash flows that do not vary based on the returns on underlying items are discussed in questions 3.11–3.25. Discount rates for cash flows that do vary based on the returns on underlying items[12] are discussed in questions 3.26–3.32. Discounting related to the premium allocation approach (PAA) is covered in questions 3.33–3.36 and locked-in discount rates are discussed in questions 3.37–3.46.

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

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

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

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

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

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

General topics

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

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

Principle 1: Estimates of future cash flows are adjusted for the time value of money and the financial risks related to those cash flows, to the extent that the financial risks are not included in the estimates of cash flows (paragraph 36).

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

[12] In most instances the standard refers to 'cash flows that do not vary based on the returns on any underlying items' and 'cash flows that vary based on the returns on any underlying items.' Only in paragraph B74b did the standard refer to 'cash flows that vary based on the returns on any financial underlying items.' For the purposes of this IAN all references will be to 'underlying items.'

- For some insurance contracts, e.g., most non-life insurance and non-participating traditional term life or non-participating whole life insurance, the cash flows are not dependent on underlying items. IFRS 17 refers to these products as having *cash flows that **do not** vary based on the returns on any underlying items*. The discounting for these cash flows is discussed in questions 3.11–3.25;
- Other insurance contracts, e.g., unit-linked universal life insurance, variable annuities, and traditional product with benefits depending on profit sharing may have cash flows that are dependent on underlying items. IFRS 17 refers to these products as having *cash flows that vary based on the returns of any underlying items*. The discounting for these cash flows is discussed in questions 3.26–3.32;
- Based on the definitions in the standard, the distinction between cash flows that do vary based on the returns on underlying items and cash flows that do not vary based on underlying items is not equal to the distinction between insurance contracts with direct participation features and insurance contracts without direct participation features. This is further explained in question 3.9.

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

- The discount rates applicable to fully liquid instruments are discussed in question 3.11;
- The liquidity characteristics of insurance contracts are discussed in questions 3.15–3.18.

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

- The concept of a reference portfolio is discussed in question 3.14.
- It may be possible to determine the discount rates for a collective of insurance contracts by identifying a replicating portfolio. This is discussed in question 3.30.

Principle 5: Estimates of discount rates are consistent with other estimates used to measure insurance contracts to avoid double counting or omissions (paragraph B74). For example, if nominal cash flows include the effect of inflation, they are discounted at rates that include the effect of inflation. Similarly, when discounting cash flows that vary with underlying items, the discount rates would reflect that variability (see questions 3.27 and further).

3.2. For which purposes are discount rates required?

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

An entity shall use the following discount rates in applying IFRS 17:	
a) *to measure the fulfilment cash flows – current discount rates applying paragraph 36.*	Discussed in questions 3.11-3.25
b) *to determine the interest to accrete on the contractual service margin […] for insurance contracts without direct participation features – discount rates determined at the date of initial recognition […].*	Discussed in question 3.37
c) *to measure the changes to the contractual service margin […] for insurance contracts without direct participation features – discount rates […] determined on initial recognition.*	Discussed in question 3.38
d) for groups of contracts applying the premium allocation approach that have a significant financing component, to adjust the carrying amount of the liability for remaining coverage […] – discount rate […] determined on initial recognition.	Discussed in questions 3.34 and 3.35
e) If an entity chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income (IFRS 17.88), to determine the amount of the insurance finance income or expenses included in profit or loss:	
(i) for groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders […] – discount rates determined at the date of initial recognition […];	Discussed in question 3.39
(ii) for groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to policyholders […] – discount rates that allocate the remaining revised expected finance income or expense […] at a constant rate; and	Discussed in question 3.40
(iii) for groups of contracts applying the premium allocation approach […] – discount rates determined at the date of the incurred claim […].	Discussed in question 3.36

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

A liquid risk-free yield curve is discussed in paragraphs B80 and BC193 – BC196. It is the basis of the bottom-up approach which is discussed in question 3.11. The liquid risk-free

curve may not be required in the top-down approach (which is discussed in question 3.13).

As IFRS 17 is principle based, it does not prescribe the details how to derive the liquid risk-free yield curve. Favourable characteristics for market quoted interest rates used in deriving a liquid risk-free yield curve might include those quoted interest rates:

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

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

Some options and considerations that might be applied are set out below[13]:

a. Government bond rates

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

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

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

b. Swap Curve

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

Swaps are often used as instruments for replicating and hedging interest rate risk which makes them a natural reference to derive risk-free interest rates for certain

[13] Other publications on the subject could help the practitioner to derive such a curve (for example: (EIOPA, 2018), (IAA, 2013)).

currencies. Furthermore, swap contracts are typically collateralised and there is no risk on the principal value associated with the swap agreement, which substantially reduces the exposure to losses associated with a credit default event. For example, the EIOPA Solvency II approach[14] uses Swap Rates for currencies with deep financial markets.

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

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

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

c. Corporate Bond Rates

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

3.4. How can risk free rates be determined if there is not a well-developed bond or swap market?

When, for a given currency, there is not a well-developed bond or swap market other approaches may be considered. Two situations can be distinguished:

a. The local currency is pegged to another currency;

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

The local currency is pegged to another currency

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

[14] Note that the volatility adjustment may not be appropriate under IFRS 17.

deviations in the past from the pegging policy may be an indicator for a correction on the targeted difference.

The local currency is not pegged to another currency

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

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

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

3.5. How is inflation reflected?

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

Cash flows subject to inflation may therefore either

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

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

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

- ***Market based approaches***

  Estimating inflation by taking the difference between nominal bond yields and inflation-linked bonds. The difference may need to be adjusted to exclude the effect of any perceived inflation risk premium. This method requires limited judgement where the issuer / credit risk of the bonds is the same, otherwise judgement / subjectivity is involved in making further adjustments for differences in yield due to credit risk. More

considerations may be required because in some markets, while the nominal bond market is considered reliable and well-functioning, the index-linked bond yields may be biased because of smaller volumes on issue and other supply/demand factors. This would then bias the derived estimate of inflation.

Inflation swaps/other market instruments – investment banks or other traders may offer contracts with a payout that is linked to future inflation. These may not be common, causing possible biases given limited availability. Where such trades occur, the prices may not be readily and publicly available. Nonetheless, where such information is available it may assist by providing insight into market information on inflation estimates.

- ***Publicly available estimates***
  - Central bank targets for inflation.
  - Forecasts of economic commentators and/or government bodies.
  - Views of a long-term real risk-free rate. This is discussed further in question 3.24. This may assist with setting the long-term inflation estimate but is likely to be less helpful in setting short-term estimates.

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

  Potential causes of differences include:

  - The corresponding central banks may not always achieve their targets which may lead to different economic expectations over the long run;
  - Market based estimates can be biased due to limited volume of transactions available.

Some cash flows of an insurance contract may be linked to salary inflation which, over time, is likely to differ from a commonly available index such as the consumer price index (CPI).

Future cash flows may depend on an inflation index that is not equal to the CPI. If this is the case, the appropriate inflation expectation would need to be used in the measurement, or in accordance with paragraph B74d, where the inflation component is excluded from both the cash flows and the discount rate. Whilst projected CPI (in this example) would be considered part of financial risk for measurement purposes, inflation assumptions for expenses or other cash flows could be considered non-financial risk (as per IFRS17.B128), with implications for presentation and the determination of the risk adjustment.

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

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

Non-performance risk with respect to reinsurers is included in the projection of future cash flows for reinsurance contracts held. See question 9.9.

With respect to application of fair value, defined in IFRS 13, in the context of IFRS 17, see question 10.5.

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

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

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

Only investment administration costs that affect the return of the underlying items would be reflected in the cash flows. Other investment administration costs are not relevant to insurance contracts.

3.8. How are discount rates updated?

Paragraph 36 (b) requires that the discount rate *be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity*. Observable current market prices correspond to the value of market instruments at the reporting date and are therefore updated at each subsequent reporting period to remain current. Unobservable inputs for which estimation techniques are necessary are developed using the best information available in the circumstances applying paragraph B78 (a). These might be updated less frequently than every reporting period. All financial assumptions used to derive yield curves are expected to be appropriate at the reporting date.

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

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

Note that all contracts with direct participation features, by definition, have contractual terms that specify that the policyholder participates in a share of a clearly identified pool of underlying items. These underlying items are mostly (but not always) at least partially financial in nature and the contracts have cash flows that vary based on the returns on underlying items.

For contracts with sharing of returns on underlying items that do not meet the definition in Appendix A of IFRS 17, the GMA is used, while for 'contracts with direct participation features', the VFA is used. In this chapter, we distinguish between "cash flows that do not vary based on the returns on any underlying items" and "cash flows that do vary based on the returns on any underlying items" in order to describe the techniques deriving appropriate discount rates for the discounting of the fulfillment cash flows. A further explanation of participation features and the description of underlying items can be found in Chapter 8 "Contracts with participation features and other variable cash flows".

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

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

See question 3.43 for a discussion of effective constant discount rates in the context of the locked-in curve.

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

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

Paragraphs B80 to B85 establish two methods to determine rates for discounting cash flows that do not vary based on the returns of underlying items, the bottom-up approach (paragraph B80) and the top-down approach (paragraphs B81 to B85). The discount curve for cash flows that do not vary based on the returns on any underlying items can also be used to discount cash flows that vary based on the returns of underlying items. Therefore, questions 3.11 to 3.25 are also relevant for cash flows that vary based on the returns on any underlying items. For the discounting of cash flows that vary based on the returns of underlying items additional considerations apply which are explained in the next section.

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

approach an entity need not make an adjustment for any remaining differences in liquidity characteristics between the reference portfolio and the insurance contracts.

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

As per paragraph B81 the entity is not required to reconcile the bottom-up approach with the top-down approach.

The choice of reference portfolio may be different for different portfolios of insurance contracts. If there is a close link between assets and liabilities for some portfolios, a reference portfolio of own assets may be more feasible than for portfolios of insurance contracts where there is not a close link with the assets.

3.12. How does the bottom-up approach work?

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

a. a liquid risk-free yield curve;

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

3.13. How does the top-down approach work?

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

IFRS 17 does not require that adjustments be made for residual differences in liquidity characteristics of the insurance contracts and the reference portfolio. However, the entity would adjust for differences if the liquidity characteristics of the assets in the chosen reference portfolio are not reasonably consistent with the liquidity characteristics of the insurance contracts, as discussed in questions 3.15–3.18.

3.14. What is a reference portfolio?

IFRS 17 has no specific requirements for the reference portfolio. It could be based on actual assets held by the entity or on a reference portfolio of assets. However, the closer the reference portfolio reflects the characteristics (e.g., liquidity) of the insurance contracts for which the discount rate is being developed, the smaller adjustments are likely to be needed in the discount rate. When the reference portfolio (if it is the actual assets held by the entity) significantly changes, an assessment on whether the reference portfolio still reflects the characteristics of the contracts materially would be done.

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

i. **Investment risks**: Investment risk can consist of credit risk, market risk, and other price risks that are inherent in the reference portfolio and are not inherent in the insurance contracts. Methods used to adjust for these elements are discussed in question 3.19 (credit risk) and question 3.20 (market and other risks);

ii. **Timing**: The timing of cash flows within the reference portfolio may not be the same as that of the insurance contracts. Adjustments may be considered, based on observable assets traded in active markets or on estimation techniques if the market is not active or no market exists. Estimation techniques for discount rates on long duration cash flows are discussed in questions 3.22–3.25; and

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

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

3.15. What are the liquidity characteristics of insurance contracts?

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

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

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

This answer addresses the liquidity characteristics of insurance contracts from the perspective of the contract's features.

Note that this answer focuses on qualitative assessments of insurance contract liquidity. See response to question 3.16 for a discussion on the quantitative assessment of illiquidity premium.

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

- **Exit value:** all else being equal, a contract where upon exit all / a large part of the value build-up is paid out is more liquid than one that pays out none or a small part of the value build-up. If on exit of a contract there is:

- Value in the contract and the policyholder receives all/a large part of the value of the contract, then the contract may be considered to be liquid.
- Value in the contract and the policyholder receives no/a small part of the value of the contract, then the contract may be considered to be illiquid

The concept of exit value aligns with the payments (that would actually be received by the contract holder) as referred to in paragraph BC193 which implies that illiquidity exists if "*the entity cannot be forced to make payments earlier than the occurrence of insured events or dates specified in the contract.*"

- **Exit costs:** all else being equal, a contract with exit costs (e.g., surrender charges / penalties) is likely to be more illiquid than one without. Note exit is contemplated as voluntary exit / cancellation of contract and occurrence of the insured event is not considered a contract exit, as contemplated in this response.
- **Inherent value / value build-up:** The inherent value / value build-up represents the contract holder's perceived value of the contract. The inherent value would include the payment the contract holder might reasonably expect to receive, if the contract holder could force the entity to make a payment. Paragraph BC193 suggests that illiquidity exists if "*the entity cannot be forced to make payments earlier than the occurrence of insured events or dates specified in the contract.*"

  For example, one could approximate the inherent value prospectively as the present value of the benefits expected to be received less the premiums that remain to be paid, within the contract boundary. Qualitatively the inherent value, may also capture other considerations such as insurability considerations or considerations regarding the cost of a replacement contract. The inherent value would be less than the insured amount, given that the insured event has not occurred.

  For example, yearly renewable non-life insurance contracts whose design are not intended to build-up value in the contract and are without exit costs, are likely to be considered liquid (for the liability for remaining coverage).

  For contracts with no cash value, increasing risk and level premium payment, contracts with longer contract boundaries are less liquid than contracts with shorter boundaries as the extended boundary leads to greater inherent value / value build-up.

  Ultimately, in all examples, above, the illiquidity is affected by the disparity between inherent value and exit value:

  - The liability for remaining coverage for a contract with little inherent value/value build-up is likely to be liquid
  - The liability for remaining coverage for a contract with a lot of inherent value/value build-up and comparatively large exit value (no significant surrender penalty) is likely to be liquid

- The liability for remaining coverage for a contract with a lot of inherent value/value build-up but little to no exit value is likely to be illiquid

Policyholder behaviour such as lapse and surrender activity for groups of insurance contracts may be an indicator of liquidity (similar to the trading activity of an asset).

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

The repayment of unearned annual premiums on exit of a contract is not considered to be an exit value payment in this context as they are a repayment of prepaid premiums and not of the value build-up. Therefore, contracts with annual premiums would have similar liquidity characteristics as the same contract with monthly premiums. Forfeiture, though, of annual premiums on exit when no penalty would have existed for monthly premium policyholders, may mean different liquidity characteristics.

The liquidity of an insurance contract could vary over time (after the date of inception of the contract). For example:

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

In any case, it is acceptable practice that an overall assessment / categorisation be made, consistent with the response in question 3.17.

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

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

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

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

There is no general accepted practice yet for the quantification of the illiquidity premium. Data relating to illiquidity premium of insurance contracts is generally not directly available in the market. Looking beyond insurance contracts, market prices for liabilities where the issuer of debt has the possibility to redeem the debt early are also very limited.

A theoretical approach to determine the illiquidity premium is to assess possible replicating portfolios. Using that approach a reference portfolio is used for the derivation of the illiquidity premium. Note that this reference portfolio is a different concept than the reference portfolio for the top-down approach. This is discussed in question 3.30. Some practical approaches of estimating illiquidity premiums for insurance contracts include:

- Using a reference portfolio and determining its illiquidity premium using top-down techniques (see questions 3.19–3.20); and
- Comparing yields on illiquid and liquid assets, both with the same or similar degree of credit risk. The commonality in these approaches is that the instruments are considered to have the same degree of credit risk and as such the spread difference would be largely attributable to liquidity. For example:
    - Covered vs risk-free bonds: Covered bonds are illiquid bonds which are backed by collateral and as such, are considered safe;
    - Public and private debt issued by the same issuer; and
    - Highly liquid and less liquid mortgage backed securities.

If the asset portfolio used in estimation is more, or less, liquid than the insurance contracts being considered, then additional adjustments may be needed.

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

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

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

Little is known about the term structure of illiquidity premium in current research. One reference that discusses the term structure of the illiquidity premium is (Kempf, 2011). Note that if the liquidity characteristics vary over time, then the implicit illiquidity premium in the discount rate would also be expected to vary over time. This being said, IFRS 17 does not specifically require this to be taken into account when establishing the illiquidity premiums.

When an asset portfolio is used to build the illiquidity premium proxy, the pattern of illiquidity can be derived from the illiquidity premiums estimated based on assets with different maturities within the portfolio. However, when there is some lack of data to estimate the illiquidity premium (e.g., there is no observable market rates for some duration), another reasonable assumption shall be used (e.g., last observable illiquidity premium, convergence toward an ultimate illiquidity premium, …). Materiality / modelling and operational considerations will also influence the approach choice.

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

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

Insurance contracts exhibiting different features may have different terms and conditions for the forced early payments (see paragraph B79), exit costs, inherent value and / or exit value. As such, products are expected to have different illiquidity premiums. For operational reasons, insurance contracts with similar liquidity characteristics can be regrouped together in buckets, in order to perform the illiquidity premium estimation for the bucket as a whole. The buckets (similar liquidity characteristics) should not be confused with the portfolios (similar risks and managed together). Two insurance contracts included in the same portfolio could be allocated to two different buckets. Likewise, two insurance contracts belonging to the same bucket could be included in two different *portfolios*.

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

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

Paragraph 63 states that "*the entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts*".

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

The key difference arises due to termination conditions.

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

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

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

ii. ***Structural-model techniques*** such as the Merton Model, Leland and Toft Model and EDF-Based Model. These models put in relation the capital structure of an entity to an option on the equity of the same entity and the value of its debt. For further

information see the IAA Discount Rate Monograph Section IV and Agrawal, Arora and Bohn.[15]

iii. ***Expected/Unexpected Credit Loss (ECL/UCL) models***: ECL models usually comprise an estimation of the probability of defaults (including the future cost of downgrades) and an estimation of the loss given default. One could leverage on models developed for calculating the IFRS 9 lifetime impairment provision (e.g., one-parameter representation of credit risk with transition matrices[16], …). Usually based on historical information, point-in-time adjustments might be needed to calibrate estimates to current market conditions and forward-looking information (e.g., Multi-state Markov Modeling[17], probit/logit models[18], …). UCL models could be based on an adjustment to reach a selected percentile credit loss level (confidence level approach). UCL could also be estimated as the compensation required by an investor to bear the credit risk associated with the instrument (cost of capital approach).

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

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

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

c. Deduction for credit risk = Expected Default Rate * (1+factor for unexpected default)

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

As mentioned in paragraph B85, IFRS 17 does not specify restrictions on the reference portfolio of assets used in applying paragraph B81. Non-fixed income assets (e.g., equity or real estate investments) may also be considered in the reference portfolio. However, the estimation process of the illiquidity premium related to these assets may be much more challenging since many risks are specific to these investments and not related to the insurance contract characteristics. Here are some examples: systematic market risks (recessions, natural disasters, geopolitical events …), tax effects, asset deterioration, variability in amount and timing of dividend, the risk of delay in finding a new tenant, obsolescence and unexpected deterioration.

For fixed income assets, other market factors, such as market sentiment and market inefficiencies, might also influence the reference portfolio yield and might result in some

[15] Agrawal, Arora and Bohn

[16] A one-parameter representation of credit risk and transition matrices, JP Morgan

[17] Multi-State Markov Modeling of IFRS9 Default Probability Term Structure in OFSAA, Oracle Whitepaper

[18] Bank default prediction models, A comparison and an application to credit rating transitions, Stefan van der Ploeg

fluctuations in the overall spread. Such factors are difficult to quantify, making the estimation of adjustments even more challenging. Unless measured and treated separately, these factors might be attributed to the illiquidity component.

3.21. To what extent do changes in actual assets held affect the discount rates?

IFRS 17 permits an entity to not adjust for liquidity differences, therefore the changes in the portfolio's liquidity could be reflected in the changes in the discount rates used to measure the related insurance contracts, even if the liquidity characteristics of the insurance contracts themselves have not changed. As mentioned in paragraph B85, IFRS 17 does not specify restrictions on the reference portfolio. Since the reference portfolio is an input to estimating the discount rates, changing the composition of the reference portfolio might result in the need to describe the change and the effect in the notes. That applies as well if the reference portfolio is chosen to be the assets actually held by the entity and the entity changes the composition of its assets. In paper AP02 of the September 2018 TRG, the situation of a change in the reference portfolio has been discussed for the situation that the reference portfolio is equal to the company's assets portfolio. The TRG concluded that two disclosure requirements were helpful:

- the methods used to determine discount rates and the processes for estimating the inputs to those methods, including the identification of a reference portfolio, the adjustments to the yield curve to determine the discount rates and the use of the simplification mentioned in paragraph B81 of IFRS 17; and
- the effect of a change in the composition of the assets in the reference portfolio on discount rates used to measure insurance contracts, if material.

3.22. How could the discount curve be extended beyond available market data?

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

In Chapter V of the Discount Rate Monograph some examples of possible approaches of interpolation and extrapolation are presented.

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

3.23. When does the observable market end?

The determination of the end of the observable market is a function of the financial market being considered.

In general, IFRS 17 requires the use of market data when available. For example, if the market for the available financial instruments in the reference portfolio would end after 10 years and market data is available for a bottom-up approach up to 30 years, an entity using the top-down approach would adopt an approach where the illiquidity premium in the discount rates for years 10 through 30 was reasonable in light of the observable risk-free rates in years 10 through 30.

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

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

For example, in a given market, 1, 3, 5, 7, 10, 20 and 30-year instruments may be available and 50-year instruments may infrequently be traded. In this example, since the 50-year instrument is infrequently traded, data at the 50-year point would have less relevance for construction of the curve. The core premise in determining the end of the observable market is determining the last point at which "available and relevant" market data exist for construction of the yield curve, consistent with paragraph B78.[19]

If a reference portfolio is used in setting discount rates, it may be difficult to split the spread on the reference portfolio assets between a credit spread and an illiquidity premium. This may be especially challenging for longer durations. In those situations, estimation techniques might be used for this split.

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

The following two approaches are often used:

- Continuation of the last observable rate; and
- extrapolation of the last observable rate to an ultimate rate.

Extrapolation that continues the last observable rate as a constant has the advantage of simplicity and is based on the last observable information. On the other hand, extrapolating to an ultimate rate might have the advantage of including additional market inputs and may be considered more consistent with paragraph B82(c) (i.e., more weight on long-term estimates than on short term fluctuations). Setting an ultimate rate is discussed in question 3.25.

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

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

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

3.25. How is the ultimate rate level set?

In the process of setting the ultimate rate, both prospective and retrospective approaches might be considered. According to paragraph B44 "*Estimates of market variables shall be consistent with observable market prices at the measurement date. An entity shall maximise the use of observable inputs and shall not substitute its own estimates for observable market data*". Further, the information used in the estimation would need to be appropriate for the expectations for the long durations of the ultimate rate. Technically, we can split the ultimate assumption in two: the ultimate risk-free rate and the ultimate illiquidity premium. For long durations the illiquidity premium is difficult to measure, but on the other hand it seems reasonable that market participants would require an illiquidity premium for long durations.

A very simple prospective approach would be to use the forward rate or spot rate at the last liquid point/to the end of the observable period. Another approach might be to make use of well-known economic metrics reflecting market participant expectations. Examples of useful metrics to estimate the ultimate risk-free rate are the central bank inflation target or neutral rates[20] and OECD GDP growth forecasts.

On the other hand, a retrospective approach has the advantage of simplicity. However, macroeconomic fundamentals may have changed over time and history may not repeat in the future as macroeconomic factors have evolved. Furthermore, the choice of the starting point could be considered to be arbitrary. The observable period may be chosen

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

to be long enough to eliminate or significantly reduce cyclic effects, but be short enough to reflect recent trends and adjust to current economic environment. Examples of retrospective approaches include using an arithmetic mean (with assumed underlying normal distribution) or a geometric mean (with assumed underlying lognormal distribution) of the historical nominal interest rate or real-rate.

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

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

For major economies, the ultimate level influences only cash flows a number of decades in the future. This suggests that care is needed in applying relatively recent history, given the length of time available for this to unwind/revert.

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

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

Cash flows may depend on the returns on underlying items[21]. Questions 3.26 to 3.32 discuss how the discount rate reflects the variability. It is important to distinguish between a linear and a non-linear dependence. A non-linear dependence can be, for example, caused by a combination of dependence of the cash flows on the returns of underlying items and a guarantee on the return of those underlying items. The approach to be used in the situation of linear dependence is discussed in question 3.27 and the approach to be used in the situation of non-linear dependence is discussed in question 3.28.

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

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

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

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

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

For linear dependence, this means that projection assumptions should be consistent with discounting to ensure an appropriate approach whether deterministic or stochastic methods are used. Deterministic methods are possible where there is linear dependence, i.e., where cash flows that vary based on the returns on any underlying items are not subject to embedded options or guarantees.

Under (i), cash flows are projected based on the expected returns of the underlying items. This should be performed as per the second bullet in question 3.28.

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

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

Replicating portfolio techniques (paragraphs B46 and B47) can also be useful to reflect linear dependence. These are discussed in question 3.30.

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

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

Here is a non-exhaustive list of approaches that might be used if the dependence of the cash flows on the underlying items is non-linear, noting the requirement for the measurement to be consistent with observable market prices (paragraph B48). In principle, with proper calibration, results of the different approaches listed below are expected to be comparable since they are all expected to be market-consistent:

- Stochastic modelling techniques based on risk neutral scenarios for investment returns on underlying items[22]. In this technique, the projected average investment returns on the underlying items are calibrated to be equal to the deterministic risk-free discount rate (with adjustment for illiquidity as appropriate). In each scenario, the net present value is calculated (using discount rates with adjustment for illiquidity as appropriate). The value of the cash flows of the insurance contract is equal to the average of the net present values of all scenarios.
- Stochastic modelling techniques based on real world scenarios for investment returns on underlying items. The underlying items are projected on a stochastic real-world basis. The discounting is done in a manner that reflects the market-consistent price of guarantees. One example to reflect it would be to use a stochastic real-world deflator set. (See IAA Monograph on Stochastic Modeling.) Also, in this approach, the net present value is calculated for each scenario. The value of the cash flows of the insurance contract is equal to the average of the net present values of all scenarios.
- Replicating portfolio techniques (paragraphs B46 and B47). These are discussed in question 3.30.
- A closed form (analytic) solution might also be used where this exists depending on the nature of non-linear dependence. This approach is attractive for operational/ speed/labour reasons where materiality considerations permit

3.29. When do cash flows need to be disaggregated?

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

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

In some other cases, it might be easier using stochastic techniques than trying to divide the cash flows.

3.30. How can replicating portfolios be used?

Paragraph B46 states that "*an important application of market variables is the notion of a replicating asset or a replicating portfolio of assets. A replicating asset is one whose cash*

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

flows exactly match, in all scenarios, the contractual cash flows of a group of insurance contracts in amount, timing and uncertainty. […] If a replicating portfolio exists for some of the cash flows that arise from a group of insurance contracts, the entity can use the fair value of those assets to measure the relevant fulfilment cash flows instead of explicitly estimating the cash flows and discount rate."

It might not be possible to find a replicating asset that exactly matches the insurance contract cash flows in all scenarios. Even for isolated cash flows, an exact matching may not be possible. Accordingly, it might be hard to apply paragraph B46 in practice.

Nonetheless, replicating portfolios may exist to some extent for some of the cash flows that arise from insurance contracts. One may also strive to find a portfolio of assets that will reproduce some characteristics of the insurance contracts. As per paragraph B48, "*judgement is required to determine the technique that best meets the objective of consistency with observable market variables in specific circumstances*". As per paragraph B78(c), "*in applying an estimation technique, an entity shall exercise judgement 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 those prices to reflect the differences between them*". The general process might start with the simplest method and progress to the use of more involved methods as necessary.

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

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

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

iii. **Dynamic replication**: Stochastic valuation techniques are used to derive risk-factor sensitivities for the insurance contract cash flows that can be replicated directly. These liability sensitivities are collectively referred to as the liability 'greeks'. Assets are identified (e.g., futures, swaps, options, …) to construct the replicating portfolio by matching the corresponding asset/liability 'greeks'.

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

3.31. How is the discount rate adjusted for illiquidity if cash flows do vary based on the returns on underlying items?

The response to questions 3.15 to 3.18 explain the assessment of contract liquidity and the resulting application of liquidity premiums in discount rates.

Cash flows that accrue to the holder of an insurance contract may depend on a combination of the return on underlying items, a guarantee on the return of the underlying items and other insurance cash flows subject to non-financial risk. All the following elements contribute, depending on their significance in the value of the cash flows, to the overall illiquidity:

- the illiquidity premium from the financial underlying items;
- the guarantee on the return on the underlying items; and
- other insurance cash flows subject to non-financial risk.

For a traditional product with a guaranteed interest rate, the illiquidity would typically depend on the surrender penalty. If the return on the underlying item for profit sharing would include an illiquidity premium, the discount rate would also have to include this illiquidity premium.

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

The risk adjustment reflects the uncertainty of non-financial risk and is distinct from the present value of future cash flows, which includes provision for financial risk.

3.32. How are future cash flows adjusted for financial risk?

The market variables that need calibration include the level of interest rates (the yield curve), the volatility of interest rates, and the market price of risk. Either real-world or risk-neutral techniques can be used for the calibration. Real-world techniques calibrate a set of scenarios to a real world expected level, consistent with prices of financial instruments available in the market, and volatility of expected market returns directly, then make a separate adjustment for the market price of risk using deflators, the cost of capital, or other methods. Hence, if a guarantee (putting aside insurance risk) might reproduce the underlying guarantee in an insurance product, the price will be equivalent, to remain arbitrage free. Risk-neutral techniques calibrate a set of scenarios by adjusting the observed level and volatility of interest rates to reflect the market price of risk based on market prices of derivatives. When using risk-neutral scenarios, no separate adjustment for the market price of risk is required because it is implicit in calibration of the scenarios themselves and in the cash flows generated based on the scenarios.

Premium Allocation Approach (PAA)

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

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

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

If the duration of a contract is longer than a year, one would need evidence that the financing component in the liability for remaining coverage is not significant. One approach would be to always take into account a discount rate if the duration is longer than one year.

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

For the liability for remaining coverage of contracts with a significant financing component within a group of contracts where discounting is applied, as stated in paragraph 56, the discount rates are the locked-in rates at initial recognition of the group of insurance contracts (paragraph B72(d)).

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

If the group of insurance contracts becomes onerous (as per paragraph 57 (b)), the difference between the carrying amount of the liability for remaining coverage using PAA (paragraph 55) and the fulfilment cash flows that relate to remaining coverage of the group (applying paragraphs 33-37 and paragraphs B36-B92) should be calculated. The calculation of fulfilment cash flows uses either the current rate or not discounted at all if the liability for incurred claims is not discounted (as per paragraph 59 (b)).

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

For incurred claims, discount rates are used unless cash flows are expected to be paid or received in one year or less from the date the claims are incurred, and the PAA is applied. The calculation of liability values uses the current rate for the balance sheet. For the P&L, the locked-in rate is used if the OCI option is applied. Otherwise, the current rate is also used for the P&L. When PAA is applied, the locked-in rate is as at the date the claim was incurred. If the GMA is applied, the locked in rate as at the date of the initial recognition of the group insurance contracts.

Locked-in rates

3.37. What interest rates are used to accrete the CSM?

For contracts without direct participation features, the interest rate accreted on the CSM is based on the discount rates as applied at initial recognition of the group for cash flows that do not vary based on returns on underlying items (paragraph B72(b)). It is not adjusted to reflect the variability of the cash flows (paragraph B74(bi)). It may include an illiquidity premium. This is referred to as the locked-in curve.

IFRS 17 is not specific regarding the method to roll forward the curve. One approach might be to derive each year's discount factors with the forward rate for that year, from the locked-in curve. This forward rate would be the rate to accrete on the CSM. Another possibility is to use the effective rate if derived at the inception although it is quite dependent on cash flow pattern.

If there are direct participation features, the change in the entity's share of the fair value of underlying items adjusts the CSM, which is effectively the same as accreting interest on the CSM at current rates (paragraph B112).

3.38. What discount rate is used to measure adjustments that adjust the CSM?

It is the discount rates determined at initial contract recognition for cash flows that do not vary based on the return of underlying items. For contracts without direct participation features in the contract, the discount rate used to measure changes that adjust the CSM is the same as the discount rate described in question 3.37.

For contracts with direct participation features, changes are measured using the current rate.

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

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

3.40. How is the OCI option applied for groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to policyholders?

These contracts have participation features, but fail to meet the definition of "insurance contracts with direct participation features" or these contracts meet the definition but the entity doesn't hold the underlying items. If the entity chooses to recognise insurance finance income or expenses in OCI, rates are used that allocate the remaining revised

expected finance income or expenses over the remaining duration of the group of contracts at a constant rate or expected credited rate[23]. (Paragraphs 88(b) and B132).

3.41. How is the OCI option applied for groups of insurance contracts with direct participation features?

Amounts in profit or loss would exactly match those related to the underlying items (paragraph B134).

3.42. Which discount rate is used for the amortization of the loss component?

After an entity has recognised a loss on an onerous group of contracts it shall, as per paragraph 50(a) allocate the subsequent changes in fulfilment cash flows of the liability for remaining coverage specified in paragraph 51 on a systematic basis between:

i. The loss component of the liability for remaining coverage; and

ii. The liability for remaining coverage, excluding the loss component.

The amortisation of the loss component can be linked to the present value of a part of the fulfilment cash flows (e.g., cash outflows). With respect to the discount rate used for the amortisation IFRS17 does not provide guidance. This discount rate might be chosen equal to the locked in rate at inception. It might also be a locked in rate at the moment that the group of insurance contracts becomes onerous. See question 6.29.

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

See question 3.10 for introductory context.

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

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

[23] See also example 15 of the Illustrative Examples.

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

The standard does not provide guidance on the potential use of a single locked in effective rate. Judgement is left for preparers of the standard.

3.44. How is the discount rate at inception used in the subsequent measurement?

The future discount curve may be derived from those forward rates at inception which are still in future at the measurement date.

3.45. Is the locked in rate always a nominal rate?

According to paragraph B74 "*estimates of discount rates shall be consistent with other estimates used to measure insurance contracts to avoid double counting or omissions*" and "*real cash flows (i.e., those that exclude the effect of inflation) shall be discounted at rates that exclude the effect of inflation*". See question 3.5. Although the standard does not specifically address this, it implies that if real rates are used, finance expenses are on a real basis as well.

3.46. How is the locked-in curve determined for a group of contracts and how does it impact interim vs annual reporting periods?

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

a. Calculating the CSM at issue for each contract within the group using the discount curve at each contract's respective issue date.

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

c. Calculating the CSM at issue for each contract using a weighted average discount curve (paragraph B73). To apply this approach suitable weights would need to be defined as they are not specified in the guidance.

The methodology for determining the locked-in curve across one or more reporting periods might be driven by the option chosen above. As per paragraph B73 a weighted average discount curve might be created. The locked-in curve could be a weighted average curve of the specific curves used (i.e., the curves to be weighted would be from the actual issue dates). The weighting could be done, for example, by considering the coverage units.

The objective of the weighted average curve is to find one curve that provides the same value as a different curve for each contract. If this would not be the case profits may arise when new policies are sold due to simplifications constructing the curve for the group. The usability of the alternative depends on the quality of the simplification / weighting process. A simple approach might be to average discount factors and derive a curve from

these factors. An alternative would be averaging spot rates. The latter method however is less likely to provide a present value equal to the present value based on the curves at the date of initial recognition of the contracts. A pragmatic approach might be reasonable because perfect weights can only be determined with several iterations. For stochastic modelling this is even more difficult.

In recognising a group of insurance contracts in a reporting period, an entity will include contracts issued by the end of the reporting period and will make estimates for the discount rates using, for example, a weighted average. The entity may issue more contracts in the group after the end of a reporting period (subject to paragraph 22), by adding the contracts to the group in the reporting period in which the contracts are issued. This may result in a different weighted average discount rates to the date of initial recognition. As per paragraph 28, the entity shall apply the revised weighted rates from the start of the reporting period in which the new contracts are added to the group. Consistent with paragraph B137, the entity does not need to change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent interim financial statements.

References

EIOPA. (2018). Technical documentation of the methodology to derive EIOPA's risk-free interest rate term structures. *EIOPA-BoS-15/035*.

IAA. (2013). *Discount Rates in Financial Reporting.*

Kempf, K. U.-H. (2011). An interesting article on the subject : The term structure of illiquidity premia, .

Rachel, S. (2015). Secular drivers of the global real. *Bank of England*.

Chapter 4 – Risk Adjustments for Non-Financial Risks

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

4.A. What does this chapter address?

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

In this chapter, the term "risk adjustment" refers to the "risk adjustment for non-financial risk", as defined in IFRS 17. In other frameworks or other documents, the term risk margins are used with many similarities, but some significant differences, to the IFRS 17 risk adjustment. The definitions and uses of the term "risk margin" are different in many references than how the term risk adjustments is defined and used within IRFS 17.

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

Paragraphs 37, 81, 101, 117–119 and paragraphs B86–B92 provide guidance on this topic.

Paragraphs BC206–BC217 also provide background on the subject.

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

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

4.1. What is a risk adjustment?

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

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

(a) the fulfilment cash flows, which comprise:

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

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

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

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

The "risk adjustment for non-financial risk" is defined in Appendix A of IFRS 17 as: "*The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts.*" A similar definition is also included in paragraph 37.

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

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

Paragraph B87 states:

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

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

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

As such, the risk adjustment measures the value of a liability related to the inherent uncertainty in the estimates of the timing and amount of cash flows associated with that liability. As IFRS 17 provides only the principles governing how this risk adjustment value should be determined, it will be important to those who determine and rely on such risk adjustment values that the quantification of such a risk adjustment liability value be based on methodologies and/or approaches that are robust (e.g., effective, tested and/or validated, where possible) and fairly reflect the IFRS 17 principles for estimating this risk adjustment value.

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

An important aspect of the communications among those responsible for determining an entity's risk adjustment is the explanation and insight regarding how the entity's views with respect to the compensation it requires for bearing risk and uncertainty have been

incorporated in the determination of the risk adjustment. Such communications will be expected to reflect a thorough understanding of the entity's views on risk aversion, risk diversification, and the uncertainty surrounding the cash flows being estimated.

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

In contrast to some financial reporting practices used previously to IFRS 17 or for non-IFRS 17 purposes, IFRS 17 requires that the entity determines an explicit risk adjustment. An implicit allowance, such as through loaded assumptions, does not satisfy this requirement.

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

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

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

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

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

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

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

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

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

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

Financial risks are excluded. Also excluded are other risks that do not arise directly from the insurance contracts, such as asset-liability mismatch risk or general operational risks (see question 4.7 for a fuller discussion of which non-financial risks are considered).

This general guidance means that there is no single correct way for an entity to set the risk adjustment. In general, some of the important considerations that will be relevant to

how an entity determines its approach to estimating the risk adjustment will include, but are not limited to:

- consistency with how the insurer assesses risk from a fulfilment perspective;
- practicality of implementation and ongoing re-measurement; and
- translation of risk adjustment for disclosure of an equivalent confidence level measure.

Therefore, a variety of methods are potentially available, although the ultimate choice depends on the extent to which the choice of method(s) conforms with the requirements of paragraph 37 and the five characteristics in paragraph B91, given the specific circumstances of the entity. Potential methods include, but are not limited to, quantile techniques, such as the confidence level or Conditional Tail Expectation ("CTE"), or cost of capital techniques. The choice may also be influenced by the entity's risk management policies and practices.

Risk adjustments are measured on a pre-tax basis.

There are also disclosure requirements related to the risk adjustment (see question 4.15 and Section E – Presentation and Disclosure).

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

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

- It can mean the two-sided risk that an outcome be greater or less than the estimated expected value of that outcome as a result of variability and uncertainty. This is the intended meaning of risk in this chapter. The terms "variability" and "uncertainty" are also used in the discussion of risk in this chapter.
- It can mean the one-sided risk that an outcome will be worse than its expected value.
- It can refer to the subject of the insurance.
- It can refer to the insured events.

In this chapter, variability refers to the statistical variation inherent in the insurance process, which leads to uncertainty in the expected future cash flows. Risk is amenable to statistical analysis of experience data. Given sufficient data, risk can be quantified in terms of the variance and higher moments of a suitable probability distribution.

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

- Uncertainty in the estimates of the mean, variance, and higher moments of a probability distribution. This uncertainty may be quantifiable as part of the statistical analysis if sufficient data are available.

- Uncertainty in the choice of probability distribution. Complex insurance processes seldom conform exactly to standard probability distributions. It may only be possible to partially quantify this uncertainty by considering alternate distributions.
- Uncertainty in the experience data that arises when the data contain more or fewer extreme events than normal. The selection of a suitable probability distribution may assist in quantifying this uncertainty.
- Uncertainty when future circumstances vary from the past. Changes in the environment, technology, and society at large are all reasons why distributions based on past experience may need to be interpreted cautiously as guides to the future. Appropriate adjustments from past to future experience are a matter of judgment and can introduce uncertainty into the future cash flows.

Chapter 2 of the IAA Monograph Risk Adjustment for Insurance Contracts Under IFRS 17 provides expanded discussions on the background and concepts for risk adjustments included in the IFRS 17 principles-based framework.

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

4.5. What risks should be considered?

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

Paragraph B89 states that:

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

Furthermore, financial risk is defined in Appendix A as:

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

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

- Claim occurrence, amount, timing, and development;
- Lapse, surrender, premium persistency, loan activity, and other policyholder actions;
- Expense risk associated with costs of servicing the contract;
- External developments and trends to the extent that they affect policyholder actions or insurance cash flows.
- Claim and expense inflation risk other than financial risk.

For the risk adjustment associated with reinsurance held, see Chapter 9 – Reinsurance.

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

- Operational risk to the extent that it is not driven by the future cash flow items above. Examples, depending on circumstances, could include legislative risk, reputational risk, business interruption/the risk of cyber attack etc.;
- Asset-liability mismatch risk;
- Price or credit risk on underlying assets.

In some instances, as noted in paragraph B53, there may be correlations and interactions between financial variables and non-financial variables that impact expected cash flows, making the distinction between financial risk and non-financial risk less clear. For example, policyholder behaviour may be influenced by investment performance where there are linkages between investment returns and credited rates and the value of the contract. In this instance, the present value of future cash flows reflects this influence of investment performance on those cash flows dependent on future policyholder behaviour. The risk that policyholder behaviour is different from what is reflected in the present value of future cash flows could be considered non-financial risk. Another example is spread compression risk due to earned and / or credited rate differences where crediting rates are discretionary. The risk that the discretionary spread compression is different from what is reflected in the present value of future cash flows could be considered a non-financial risk if it is not considered a general operational risk excluded from future cash flows.

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

In actuarial terms, the risk adjustment is intended to reflect the value of the uncertainty inherent in the cash flows of the insurance contracts – in terms of the amount and the timing of cash flows. It is expected that actuarial input, both quantitative and qualitative, will be needed. Such input may include the actuary:

- Providing quantitative measures to help evaluate the variability inherent in the insurance contracts being valued and the uncertainty which underlies such quantitative measures;
- Assisting in understanding and assessing the entity's risk aversion (i.e., attitude toward risk) related to the uncertainty and variability of insurance cash flow (see questions 4.8 and 4.9);
- Assisting in understanding the extent to which the entity considers "the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk" (paragraph B88(a));

  Assisting in designing an approach to assess a value in terms of the compensation for bearing risk that reflects the entity's risk aversion in the context of the relevant risks and in the context of the diversification affecting the compensation for such risks;
- providing explanations and insights to help in communicating the understandings and judgments involved, such that the entity's board and management can have the appropriate level of direction and oversight regarding how the risk adjustment is determined; and
- Assisting with the disclosure requirements (see questions 4.18, 4.20, and 4.21).

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

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

- the selection of the approach to estimate the risk adjustment;
- the assessment of the entity's risk aversion;
- the estimation and assessment of variability and uncertainty, depending on the data available;
- the assessment of diversification, depending on the complexity of the business written and on the entity's approach to diversification below the holding entity level (see question 4.10); and
- the assessment of how risk aversion interacts with variability and uncertainty in the determination of the risk adjustment.

Judgements may also be needed for the assumptions and other detailed elements in each of the above areas.

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

4.8. What is risk aversion and how does it relate to the risk adjustment?

Risk aversion, which is related to risk appetite, is an entity's reluctance to accept risk, particularly as respects unfavourable outcomes. To overcome this aversion, entities

typically expect compensation for bearing risk. The greater the risk aversion, the greater the compensation required. While it can be taken as a general truth that the compensation required increases as risk aversion increases, the relationship is not necessarily linear. For example, the closer an additional risk brings an entity towards its risk capacity, the entity is likely to require a compensation that is greater than simply proportionally more to accept it. In other words, risk aversion generally increases as an entity approaches its risk capacity. The risk adjustment would be measured considering the entity's overall attitude to risk.

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

The entity's risk policy may include an explicit risk aversion policy. In some cases, the actuary may be able to draw on such an explicit risk policy, such as that adopted by the entity's board, which would typically be developed in consultation with the entity's Chief Risk Officer and / or enterprise risk committee. The entity's risk policy may extend to risks (variability and uncertainty) which are excluded from the risk adjustment (such as financial risks) and risks related to contracts that are not accounted for under IFRS 17. Thus, methods would be needed to separate such risks.

When an explicit risk policy does not exist or is not applicable, discussions with the entity's board and management may be appropriate. Topics for discussion that the actuary may find useful include:

- comparison with similar entities in the market;
- discussion of stress scenarios, both short and long term;
- the entity's underwriting and pricing policy and practices;
- the entity's approach with respect to capital needs and capital management;
- the entity's approach to setting target returns; and
- the entity's reinsurance policy and practices.

Risk aversion ultimately finds its expression in the compensation that the entity requires for bearing uncertainty about the amount and timing of cash flows. See question 4.3.

4.10. What is risk diversification, how should allowance be made for it in the risk adjustment, and what level of aggregation should be used?

The risk adjustment reflects "*the degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk*" (paragraph (B88(a)). The degree of risk diversification and the method and detail in the method by which it is applied are to be included within the entity's assessment of compensation.

Paragraph B88(a) uses the term "diversification", suggesting a bottom-up approach to determining the required compensation but does not preclude a top-down approach. If an entity uses a top-down approach, the entity can determine the total compensation that it requires for bearing non-financial risk and then allocate or apportion it. For example, the entity may allocate its risk compensation to whatever level of subdivision is

required for financial reporting purposes. With this process, the extent of aggregation of the business risks for which the entity determines its total required compensation for bearing risk is the equivalent of the extent of aggregation of business over which diversification is reflected.

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

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

In some cases, most commonly for quota share and sometimes for surplus reinsurance, the gross risk measurement might be approximately proportional to the net of reinsurance risk measurement and therefore the gross risk adjustment can be estimated by using a simple scaling factor applied to the net of reinsurance risk adjustment. In other cases, there may be quantitative and qualitative aspects of the risk and uncertainty such that the reinsurance held provides a disproportionate degree of risk mitigation. For non-proportional reinsurance (such as excess of loss), the value to the entity from the risk mitigation provided by its reinsurance held is typically significantly greater than simply proportional to a selected risk measure. In some cases, it may be appropriate to consider other benchmarks or risk measures that are consistent with the entity's risk aversion (reflecting that its risk is mitigated via reinsurance) and also to consider the entity's estimate of its costs to retain, or replace, the reinsurance held.

Where reinsurance policies cover the risks of multiple portfolios of insurance contracts, it may be necessary to take a broader view and apportion the impact of the reinsurance for reporting purposes.

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

The risk adjustment may reflect the impact of diversification of non-financial risk across all of the insurance contracts that the entity selects. This may be the aggregation of all contracts to take account of all possible diversification benefits, or it may be at a lower level for sub-groups comprised of specific contracts or cohorts of business. The key

consideration in making this choice is how the entity considers diversification in establishing the compensation it requires.

In a similar vein, where insurance contracts are issued by one or more subsidiaries in a group, it is open to the reporting entity to assess the risk adjustments appropriate to contracts in each subsidiary independently of any support that the holding entity may provide or to reflect that support in its risk aversion and, hence, implicitly allow for diversification across part or all of the group. This is an accounting policy decision which could be informed by the operational arrangements within the group. Paragraphs 19-21 of paper AP02 for May 2018 meeting of the IASB's TRG described the consolidated risk adjustment as the sum of the subsidiary risk adjustments.

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

The risk adjustment is intended to fully reflect all of the uncertainty in the amount and timing of insurance cash flows, incorporating allowance for all possible outcomes in proportion to their respective probabilities. This includes infrequent and atypical events in the tail of the distribution of outcomes. Where such tail events or combinations of events are not represented in the experience data, judgement may be needed as to how great an allowance is needed. Conversely, where such events are present, judgment may be needed as to whether they are disproportionally represented. It should be noted that the impact of such contingencies on uncertainty is typically proportionately greater, and may be much greater, than the impact on the corresponding expected value.

In some cases, it may be possible to fit a probability distribution that allows for extremes based on observed experience, but the suitability of the chosen probability distribution is both a matter of judgement and a source of uncertainty. It is often helpful to model extreme outcomes separately from other events.

4.12. What allowance should be made for risk-sharing mechanisms other than reinsurance?

Risk sharing mechanisms may include:

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

No allowance would be made for prospective experience rating that lies outside the contract boundary unless it affects the compensation the entity requires, as this does not relate to current contracts and is regarded as part of the underwriting process for future contracts.

Risk-sharing arrangements can affect the contractual cash flows between the insurer and the policyholder. Risk-sharing arrangements can reduce the risk of the cash flows. Risk adjustment reflects all of these contractual cash flows with due consideration to the contingencies involved.

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

The compensation that the entity requires for bearing risk is a matter of judgement, which is ultimately exercised by the management of the entity and governed by the board of the entity. Relevant actuarial input is important to both management and the board to exercise their responsibilities.

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

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

The profit margin, however, can differ quite widely for different segments of an entity's business and over time. While a profit margin may be a reasonable starting point, there are usually elements of a profit margin that are not consistent with the IFRS 17 measurement objectives for risk adjustment. For example, general overheads and operational, asset-liability matching, and financial risks (other than investment risks that are directly related to cash flows to the policyholder) would typically be included in the profit margin but are not considered in the IFRS 17 risk adjustment. Further, the IFRS 17 criterion for risk adjustment is the amount which would make the entity indifferent between uncertain cash flows and fixed cash flows. Profit margins frequently reflect different objectives (such as desired market share and market competitiveness, policyholder dividend considerations, and pricing sensitivities), which are not relevant considerations for the risk adjustment.

While regulatory regimes typically prescribe risk margins and / or capital in excess of central estimates, these values are based on a regulatory rather than an entity perspective. Furthermore, these values also typically include allowances for risks that are not considered within IFRS 17.

4.14. How should qualitative risk characteristics be reflected

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

Situations often arise where information to develop assumptions for risk, including probability models, is limited. This is most frequently the case with new markets, new risks, long duration risks, and risks involving extreme or remote events. Nevertheless, unanticipated circumstances ("unknown unknowns") can arise in almost any environment.

IFRS 17 does not specify the estimation technique(s) that an entity must use to determine the risk adjustment (paragraph B91). Thus, each entity would choose one or more techniques that appropriately reflect the available data, information, and results from the models, including the risk strategy of the management, and the extent of the uncertainty. It is important that the technique used appropriately captures the compensation for bearing the risk

Both simple and complex techniques may be appropriate, depending on the nature and significance of the uncertainty as well as the type of modelling available. For example, where uncertainty is significant and is characterised by a very low frequency and high severity risk profile, a scenario testing approach might perform better, provided suitable extreme scenarios are included. Modelling using a suitably skewed probability distribution is another approach. Where there are discontinuities and probability models are available, such a risk might be captured by introducing a state or regime switch into the model.

Qualitative risks cannot be measured directly and are seldom symmetrical. As a result, it may be appropriate to modify, based on judgement, the risk adjustment solely on the basis of knowledge of the risks involved and any observed experience that could be relevant.

Whatever approach is taken to qualitative risks, consistency over time is important. Changes in the approach used to assess qualitative risks may be warranted at times, such as when there is significant change in the perceived qualitative drivers of uncertainty.

4.15. What disclosures and explanations are required?

Paragraph 93 states:

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

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

For the most part, these disclosures relate to amounts that are inclusive of risk adjustments and are discussed in other chapters. The specific requirements in respect of risk adjustments are in paragraphs 101, 117, and 119.

Paragraph 101 states: "*For insurance contracts other than those to which the premium allocation approach described in paragraph graphs 53–59 or 69–70 has been applied, an entity shall also disclose reconciliations from the opening to the closing balances separately for each of:: … (b) the risk adjustment for non-financial risk; …*"

Paragraph 117 states:

> "*An entity shall disclose the significant judgements, and changes in those judgements, that were made … (c)(ii)to determine the risk adjustment for non-financial risk …*"

Paragraph 119 states:

> "*An entity shall disclose the confidence level used to determine the risk adjustment for non-financial risk. If the entity uses a technique other than the confidence level technique for determining the risk adjustment for non-financial risk, it shall disclose the technique used and the confidence level corresponding to the results of that technique.*"

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

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

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

- the background to the disclosures required;
- how the compensation the entity requires for bearing risk was quantified;
- how the entity's risk aversion was assessed and incorporated in considering the entity's required compensation for bearing risk;
- how risk has been identified, quantified, and translated into a risk adjustment;
- how qualitative and unknown risks were allowed for, including their relative importance, within the risk adjustment;

- how risk diversification was considered, within and across risk types and product lines, geographic divisions, across entities within a group, etc.; and
- the impact of reinsurance and other risk transfer or mitigation considerations (see Chapter 9 – Reinsurance).

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

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

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

In some cases, the entity may choose to initially calculate the risk adjustment at a level that incorporates some groups valued under the general measurement approach and others where the liability for remaining coverage is determined under the PAA, i.e., there is no risk adjustment for the PAA liability for remaining coverage. In such cases, there will still be a portion of the risk adjustment attributable to the present value of the future cash flows from unpaid claim liability associated with the PAA groups.

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

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

In order to determine confidence levels, only a portion of the probability distribution would be needed. If that probability distribution is not explicitly derived as part of the measurement process, some method or model might be needed to estimate the percentiles of that combined portfolio distribution of the fulfilment cash flows at the amount which includes the risk adjustment. The extent of the analysis needed for such estimation is likely to require judgement.

For large collections of insurance contracts, the shape of the probability distribution may be assumed based on knowledge about the characteristics of the fulfilment cash flow risks. In other situations, the form of the probability distribution might be selected based on judgement, and the parameters for that probability distribution might be selected judgementally based on what is considered appropriate for the purpose of the IFRS 17 disclosure.

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

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

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

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

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

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

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

Another important consideration is the level of precision indicated in the disclosure.

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

IFRS 17 does not specify whether the disclosure of a confidence level is intended to be on a gross or net of reinsurance basis. The entity's reported risk adjustment is disclosed on a gross level. If the entity has reinsurance held, the entity also separately discloses the risk adjustment associated with reinsurance held. The entity's net of reinsurance risk adjustment is not disclosed as a separate item. The estimation of the confidence level for disclosure does provide meaningful information on a net of reinsurance basis, as that considers the overall risk position of the entity,

The basis for the level of disclosure of the confidence level (gross and reinsurance held, or net of reinsurance, or both) is likely to emerge from practices adopted by entities reporting risk adjustments, which will be guided in turn by market practice and the technique used to determine the risk adjustment.

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

Paragraph 119 requires disclosure of the confidence level associated with the risk adjustment. IFRS 17 only requires one confidence level disclosure for the reporting entity. However, additional disclosure at a more granular level is not prohibited.

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

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

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

While it may often be desirable to make use of analyses conducted for other purposes, the conclusions drawn from such analyses may not be transferrable. Such conclusions depend on the perspective and purpose for which they are required. Risk adjustments are set in a fulfilment perspective in comparison to expected values, that are required to represent unbiased mean values. This is not necessarily true of measurements set in other contexts.

For further detailed discussion on this topic, refer to the IAA Monograph *Risk Adjustments for Insurance Contracts Under IFRS 17*.

4.23. To what extent can different approaches be used to determine the risk adjustment for different groups of insurance contracts?

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

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

The "*compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk*" (paragraph 37) refers to the time horizon which includes all future cash flows within the contract boundary for all insurance contracts in force at the reporting date until reaching their contract boundaries, as defined by IFRS 17.

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

The time horizon used for a capital measure may be different than the time horizon used in measuring the risk adjustment, without causing inconsistencies. For example, a capital measure may use a short time horizon (e.g., 1-year, with terminal provision). The measurement of risk adjustment may use, as input, a series of capital measures that each use a 1-year time horizon. For example, the capital measure may be based on a short time

horizon (using a 1-year horizon) for capital at a given point in time, then such capital measures would be projected for future time points over the contract boundary, and then each future point estimate would be multiplied by a cost of capital rate, and then discounted back to the measurement date.

Chapter 5 – Level of Aggregation

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

5.A. What does this chapter address?

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

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

Paragraphs 14–24 provide guidance on this topic.

Paragraphs BC115–BC139 also provide background on the subject.

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

None

Overview

5.1. What is the purpose of aggregation?

IFRS 17 deals purely with insurance contracts and investment contracts with *Discretionary Participating Features* (DPF). In most instances, it is likely to be impractical for an entity to measure all insurance contracts at individual contract level. Consequently, all insurance contracts in the scope of IFRS 17 may be aggregated into *portfolios of insurance contracts* ("portfolios") and *groups of insurance contracts* ("groups") within portfolios on initial recognition and not reassessed subsequently (paragraph 24). In doing so, the IASB intends to limit the obscuring of information that would occur by offsetting onerous contracts in one group with profitable or potentially onerous contracts in another *and to report the profits in appropriate reporting periods* (paragraphs BC119 and BC136).

5.2. What are the levels of aggregation?

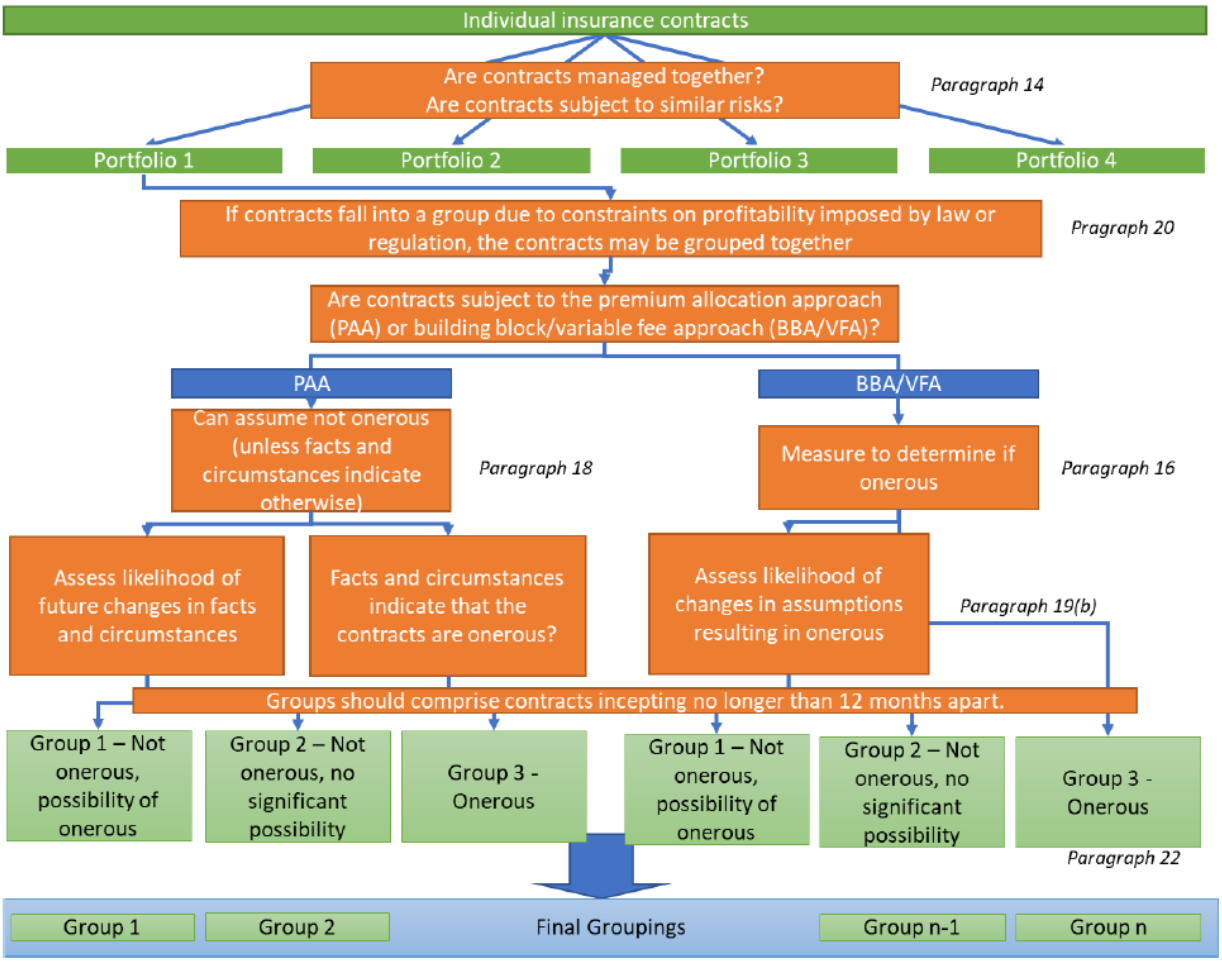
In determining the level of aggregation, an entity identifies portfolios. Each portfolio is divided into groups, which distinguish onerousness and profitability, and the entity aggregates individual contracts into these groupings. An entity cannot include contracts issued more than one year apart in the same group (paragraph 22).

The level of aggregation discussed in this chapter refers to aggregation for the purpose of measurement. Disclosures may require a different level of aggregation, and this is covered in Section E – Presentation, and Disclosure.

The group as defined by IFRS 17 is the minimum level of aggregation required. Lower levels of aggregation are permissible so long as the requirements of IFRS 17 are met.

A summary of the levels of aggregation follows in Figure 5.1.

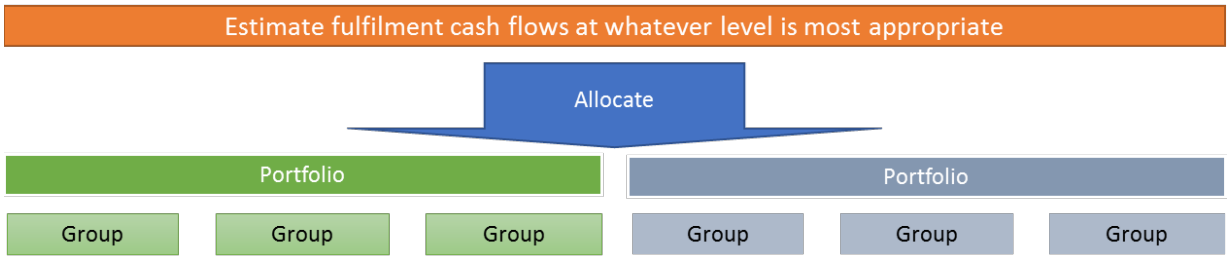
Figure 5.1: Level of aggregation



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

When measuring groups, an entity may estimate the expected present value of future cashflows, discount rates, and the risk adjustment for non-financial risk at a higher (or lower) level of aggregation than the group, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group by allocating such estimates to groups (paragraph 24). This is depicted in Figure 5.2.

Figure 5.2: Allocation of Fulfilment Cash Flows



5.4. Why is the level of aggregation important?

The level of aggregation determines the level at which the recognition and measurement requirements of IFRS 17 (paragraph 24) are applied. Measurement of the Contractual Service Margin ("CSM") and earning patterns under the Premium Allocation Approach ("PAA") are generated at group level, and, therefore, the level of aggregation affects profit recognition patterns for the entity. Groups will need to be tracked and measured throughout the coverage period of the contracts (paragraphs 40-52, 'Subsequent measurement'). Grouping ensures that there is systematic and consistent treatment of cross-subsidies between insurance contract reporting.

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

Identification of Portfolios

5.5. What is a portfolio of insurance contracts?

A portfolio of insurance contracts is defined in Appendix A as "*Insurance contracts subject to similar risks and managed together.*" Each portfolio forms a partition of the total insurance business of the reporting entity. Accordingly, each contract is, at inception, allocated to one portfolio, or may, under certain circumstances (see questions 5.8 and 5.9), be apportioned across multiple portfolios if the contract covers different types of risks which are separated into different contracts each of which is allocated to a group.

5.6. What does "subject to similar risks" mean?

No clear definition of similar risks is given in IFRS17. Paragraph 14 states: "*Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together.*"

5.7. What does "managed together" mean?

Again, there is no clear definition in IFRS17 for this term. Hence, judgement may be required on what constitutes managed together.

From a practical perspective, the considerations relating to "managed together" noted above will require assessment based on usual business practices. This may naturally result in the portfolios for IFRS 17 reporting.

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

An entity might change how it manages its business over time, and, as a result, the number of portfolios might change over time. This is an anticipated response under IFRS 17, although it does not necessarily affect the number of groups as historical groups do not change (paragraph 24).

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

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

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

- Paper AP01 for the February 18, 2018 TRG meeting and discussion thereof, which provide IASB staff views on when it may be appropriate to separate insurance contracts.
- Paragraph 9 and paper AP01 for the May 18, 2018 TRG meeting and subsequent discussion which provide IASB staff views on the combination of insurance contracts,
- Paragraph BC119 states that aggregation set by regulators serves a different purpose than aggregation for financial reporting; and
- Peril-type aggregation used for actuarial modelling in reserving would not necessarily be a suitable basis for aggregation especially if focussed solely on solvency and valuation requirements.

This supports the bundling of perils within portfolios and groups from a practical standpoint. However, if the insurance contract covers multiple perils or benefits, then separation of these components into separate contracts for accounting contracts might be possible. The attribution of premium income to multiple peril groups could be challenging, particularly if those perils were not priced explicitly within an additive pricing structure. This complexity might lead to potential inaccuracies in financial reporting, notably the consideration of whether the groups are onerous. Materiality of the potential inaccuracies in financial reporting is a consideration.

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

"..*overriding the contract unit of account presumption by separating insurance components of a single insurance contract involves significant judgement and careful consideration of all relevant facts and circumstances. It is not an accounting policy choice.*" (TRG Summary Feb 18 paragraph 7(b)(ii)).

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

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

However, there might be certain facts and circumstances where the legal form of a single contract does not reflect the substance and could therefore warrant splitting out of the different components of the contract. Examples include where transactions that are typically written as separate contracts have been bundled together as one legal contract for customer convenience or where a set or series of insurance contracts with the same or a related counterparty can be treated as a single contract. Areas to consider include the level of interdependencies between the different components of the contract (such as shared deductibles and limits) or where the lapse or termination of one component results in the termination of the whole contract.

5.10. When is a contract allocated to a portfolio?

Practically, at the same time as the contract is added to a group, i.e., the date where the contract is to be recognized according to paragraph 25 and paragraph 28 (see question 5.13).

5.11. Are portfolios fixed for all times?

The allocation to portfolios and groups is covered in paragraphs 14-16. As the definition of a portfolio refers to a purely business criterion, the contracts that are considered similar risks and managed together may change over time. IFRS 17 requires a current assessment for any new business written. Portfolios for an entity might change over time for new business or renewal business as well as for the existing in-force business.

It is possible to change portfolios, but it is not possible to change groups (unless contract modification applies – see Chapter 14 – Contract Modifications and Derecognition). A contract is required to be assigned to a group (which is a subset of a portfolio) at initial recognition of the contract, and therefore portfolios may not cut across groups.

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

Partitioning into Groups

5.12. What is a group of insurance contracts?

A group of insurance contracts is a further partition of a portfolio according to when the contract is written and the expected profitability (paragraph 16 and Appendix A). Hence, a group includes contracts that are issued no more than 12 months apart and have the property that contracts expected to be loss making are not in in the same group as

contracts expected to be profitable. A group is a sub-set of a portfolio. Each group is sometimes referred to as a "unit of account", although this term is not used in IFRS 17.

5.13. When is an issued contract grouped?

Paragraph 25 specifies that a group is recognised at the earlier of the date when insurance coverage commences or the date the initial premium becomes due or if the group is onerous, when the group becomes onerous. New contracts are added to the group as they are issued, subject to the contracts being issued no more than one year apart (see question 5.14).

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

Question 5.11 refers to portfolios changing over time if the business changes how it manages its insurance contracts.

Significant contract modifications are covered in more detail in Chapter 14 – Contract Modifications and Derecognition.

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

Contracts that legally bind the insurer for only a short period (e.g., most non-life insurance contracts) may get reissued at the renewal date. The renewed contract will be a new contract under IFRS 17, and, hence, the renewal date may be (as one interpretation of) the issue date for such contracts.

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

There is no requirement in IFRS17 for a group to cover the whole of a 12-month period nor for that period to coincide with the accounting period or a calendar year. The requirement is that the period for which contracts are grouped may be no more than one year.

The situation is more complex for contracts that bind the insurer for longer periods (e.g., most life insurance contracts). These contracts might be guaranteed renewable, and the contract legally continues subject to payment of the renewal premium due. Although the contract legally continues, IFRS 17 may treat the renewal date as the contract boundary and the renewal as creating a new "accounting-contract" for IFRS 17 purposes separate from the exiting contract. In this case, the underlying policy contract may be treated as multiple "contracts" for IFRS 17 purposes over its life (paragraph 35). In this case "issue" date may refer not to the original date of commencement but to the renewal date that incepted the accounting-contract under IFRS 17.

5.15. How is a contract allocated to a group?

Based on paragraph 16, each contract to be grouped is assigned to one of three categories:

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

b. At initial recognition, the contract has no significant possibility of becoming onerous subsequently; and

c. Any remaining contracts in the portfolio.

In practice, individual contract assignment might be possible, but insurers may choose not to determine each contract's fulfilment cashflows at issue date and may instead rely on differentiation of contracts corresponding with such elements as differentiation of risk and pricing. "Reasonable and supportable information" is the terminology used in IFRS 17. Paragraphs 17 and BC129 highlight the IASB's intention that the objective of assigning contracts to the three categories mentioned above can be achieved by assessing a set of contracts if the entity can conclude, using reasonable and supportable information, that the contracts in the set will all be in the same group.

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

5.16. How might groups be different for contracts with mutualisation features?

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

IFRS 17 specifically addresses mutualisation in paragraphs B68-B71 and B103. The overarching principle of mutualisation is that the cash flow allocation to groups is based on all rights and obligations of the portfolio that may participate in a common pool of underlying items.

The fulfilment cash flows for a group:

(a) *include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders; and*

(b) *exclude payments to policyholders in the group that, applying (a), have been included in the fulfilment cash flows of another group.*

Similarly, for this calculation, cash flows to policyholders implicitly transferred to other groups are excluded. Note this assumes that profit from the donor group has not already been released. For further detail on measurement of contracts with direct participation features, refer to Chapter 8 – Contracts with Participation Features and Other Variable Cashflows.

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

One might argue that there is no point in sub-dividing groups by year of issue, because cash flows from a more profitable cohort could be transferred to a less profitable cohort. The ability to transfer between cohorts means that the profitability for business written in separate periods may be less differentiated. There may be particular operational challenges when determining the groups in respect of businesses where new policies share in profits generated by the existing book and vice versa.

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

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

Paragraph BC138 notes that the amounts to be reported for each group are specified, but it is not necessary to calculate amounts at a group level. Thus, calculations could be undertaken at a higher (or lower) level, and the results then allocated to each group. This is important in the context of mutualisation, as IFRS 17 assumes that the amount of any transfers will be specifically known, whereas the actual quantification is likely to vary over time as facts and circumstances change. The September 2018 TRG paper AP10 contains some information on this topic.

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

As explained in question 5.5, portfolios are defined as contracts subject to similar risks and managed together. The entity will determine how risks and the management thereof are affected by the pool of underlying items.

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

5.18. How are contracts added to an existing group?

The establishment of a group can be a process that spans a period of up to one year. The original classification of the group determines the allocation of new contracts during that period. If the expected profitability of an open group changes during that period, it might be appropriate to close the open group and open a new one.

5.19. What is "reasonable and supportable information" when determining whether a set of contracts can be considered as a group?

Paragraph 17 indicates consideration should be given to the availability of reasonable and supportable information to justify the grouping of contracts. Reasonable and supportable information could be considered to be readily available internal management and reporting information. Examples might include, but are not limited to, policy disclosure statements, valuation reports, pricing reports, and other key profitability metrics presented to senior management or the Board of Directors.

In the absence of such information, an entity would determine the group to which the contracts belong by considering the fulfilment cash flows of individual contracts at the date of initial recognition (paragraph 17). Where the entity can reasonably undertake a measurement approach at an individual contract level, this would also enable a grouping assessment to be made (see also question 2.10).

5.20. What is the difference between no significant possibility of becoming onerous and other non-onerous contracts?

Paragraph BC130 discusses the intent of this separation in a limited manner.

Internal guidance might be created by an entity that specifies the details of the metrics that are required to determine whether contracts fall into the no significant possibility group. Given the judgmental nature of this determination, the approach is likely to vary across entities.

5.21. Does the liability for incurred claims need to be separated or identified by group (portfolio, underwriting year, level of onerousness)?

Paragraph 40 stipulates that:

> *The carrying amount of a group of insurance contracts at the end of each reporting period shall be the sum of:*
>
> *(a) the liability for remaining coverage […] and*
>
> *(b) the liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date…*

In practice, it is anticipated that the liability for incurred claims could be measured at a different level of aggregation than the defined groups and then allocated down or aggregated up to the adopted IFRS 17 groups. Paragraphs 24 and 33 make it clear that allocating the fulfilment cash flows to groups from a higher level of aggregation is quite acceptable for any type of valuation activity.

5.22. What happens if the interim or financial year end cut short the grouping year? Is the reported weighted discount rate restated allowing for the remaining months?

An entity may add contracts to a group as long as they are not issued more than one year apart from any other contracts in the group. As contracts are added to a group, this may result in a change in the weighted-average discount rates at the date of initial recognition

for the group. As indicated in paragraph 28, these revised discount rates are applied from the start of the reporting period in which the new contracts are added to the group, to all contracts in the group. See question 3.46 for a discussion of various options for calculating the weighted average discount rate.

Careful consideration may be needed when changing the weighted discount rate. One key consideration is paragraph B137, which provides an accounting policy choice as to whether to change the treatment of accounting estimates made in previous interim financial statements when applying IFRS 17 in subsequent financial statements and in the annual reporting period. The option chosen under B137 will affect the approach to determining the weighted average discount curve. The discount curve may be 'locked in' at the interim reporting date or retrospectively changed in subsequent interim financial statements or in the annual reporting period, depending on which option is selected.

Further Disaggregation

5.23. Is it appropriate to determine groups on a more granular level than prescribed?

There are no constraints on the refinement of groups beyond the minimum level prescribed (paragraph 21).

5.24. Can a group comprise of a single contract?

Yes, a group can comprise a single contract if that is the result of the grouping exercise (paragraph 23).

Regulatory Constraints

5.25. How does community rating and legislated limitations on use of underwriting variables impact grouping?

Where law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, those characteristics can be ignored for allocating policies between groups. Therefore, if a particular characteristic that is restricted would result in policies being split between onerous and other allocations, this characteristic can be ignored. The exemption cannot be applied by analogy to other items (paragraph 20).

An example is the gender-neutral pricing regulations in Europe, where legislation requires that males and females be included in the same group even if there is statistical evidence of differences in risk. Another example is where regulation restricts the use of age, gender, and pre-existing conditions in pricing health insurance, which could result in some policies being onerous. In these circumstances, policies that would or would not be onerous due to these characteristics may be grouped together.

5.26. How should one consider regulatory pricing constraints?

The exemption in paragraph 20 applies only when law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics. The categorisation would be applied either to the portfolio as a whole, or groups excluding the regulatory or legal constraints. Care needs to be taken

in determining the extent of the legal or regulatory constraint and delineating it from business decisions (see paragraphs BC133 and BC134).

Other Questions

5.27. How are reinsurance contracts aggregated?

The entity accounts for reinsurance contracts held separately from the underlying insurance contracts to which they relate. Entities apply the aggregation requirements in paragraph 61 to "*divide portfolios of reinsurance contracts held applying paragraphs 14–24, except that the references to onerous contracts in those paragraphs shall be replaced with a reference to contracts on which there is a net gain on initial recognition. For some reinsurance contracts held, applying paragraphs 14–24 will result in a group that comprises a single contract*".

Further discussion is presented in Chapter 9 – Reinsurance.

5.28. What reinsurance mismatches might arise?

A principle of IFRS 17 (paragraphs B66(b) and BC298) is to separate the insurance contract liability of the underlying contract from any associated liability for reinsurance held. This means, for example, an underlying contract that is onerous at inception would still be considered onerous and accounted for as such even where 100% of this risk is ceded to another party on an original-terms coinsurance basis while a gain will be recognised on the reinsurance held covering that underlying contract (see paragraphs 66A and 66B).

The variable fee approach ("VFA") cannot be applied to reinsurance held (or issued) business, even if the VFA is applied to the underlying insurance contracts (see Chapter 9 – Reinsurance). This may create mismatches in treatment between inwards and ceded business.

5.29. What are the implications of aggregation for presentation and disclosure?

An entity is required to present income or expenses from reinsurance contracts held separately from the expenses or income from underlying insurance contracts issued (paragraph 82).

Paragraph 78 requires the separate presentation of the portfolios of contracts that are issued as assets and that are issued as liabilities. Portfolios of contracts in a liability position are those where the aggregate IFRS 17 liability across the contracts in that portfolio is positive. Portfolios of contracts in an asset position are those where the aggregate IFRS 17 liability across the contracts in a portfolio is negative.

Further discussion is presented in Section E – Presentation, and Disclosure.

5.30. How are business combinations and portfolio transfers treated?

On acquisition of a portfolio or set of contracts, paragraph B93 applies. The acquirer reassesses the groups using paragraphs 14-24 to identify the groups as if the contracts had been issued on the acquisition date. As the contracts would all have the same acquisition date, the requirement relating to "issued less than 12 months apart" no longer

applies. Illustrative example 14 from IFRS 17 Illustrative Examples shows the accounting for this.

A business combination within the scope of IFRS 3 will also require additional considerations in respect of the portfolios and groups to which these contracts belong. The portfolios that were split into groups based on profitability may have changed from the original entity.

When purchasing an entity, contracts are assessed at the date of the business combination date within the scope of IFRS 3 (paragraph B93).

For intra-group transfers of business, if it is assessed as a transfer of business that is not an IFRS 3 business combination, paragraph B93 does not apply. (paragraph 39)

Further discussion is presented in Chapter 11 – Business Combinations and Portfolio Transfers.

5.31. What exceptions are allowed at transition?

This will depend on which transition method is being used to measure the group of insurance contracts. Regardless of the transition method, once adopted, groups are fixed at transition, and contracts remain in the same group thereafter.

If a full retrospective approach is adopted, as per paragraph C3, there are no exceptions and business written up to transition is grouped applying IFRS 17 retrospectively as if it had always applied. That is, groups are established as if the issuer assessed this at initial recognition of the group of contracts, with no hindsight as to the actual profitability of the contracts.

If the modified retrospective approach is applied, as per paragraphs C8 and C9, the identification of groups can be carried out with the information available at the transition date. Also, groups can include contracts issued more than one year apart. However, this modification can only be used to the extent that an entity does not have reasonable and supportable information to apply a retrospective approach. If the entity does have the information to make the split by portfolio and group for a particular group, this information should be used.

If a fair value approach is adopted, as per paragraph C23, it is permitted (but not required) to include in a group contracts issued more than one year apart. The entity can only divide into groups issued within one a year (or less) where the entity has reasonable and supportable information to make the division. The difference here is that whereas for the other two approaches the entity must make the divisions if the information is available to do so, for the fair value approach the entity is allowed (but not required) to make the divisions if the information is available to do so.

Further discussion is presented in Chapter 12 – Transition.

Chapter 6 – Contractual Service Margin and Loss Component

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

6.A. What does this chapter address?

This chapter provides information about the contractual service margin ("CSM") – what it is, how it should be determined, and how it might change because of a range of factors – and the treatment of the loss component of onerous contracts.

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

Paragraphs 38 and 39, 43–52 and B96–B119 provide guidance on this topic.

Paragraphs BC218–BC226, BC228–BC256, and BC270–BC287 also provide background on the subject.

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

None

Overview

6.1. What is the purpose of the CSM?

The CSM is defined in Appendix A of IFRS 17 and represents the unearned profit the entity will recognise as it provides services under the insurance contracts in a group of insurance contracts ("group") when the entity does not use the Premium Allocation Approach ("PAA") as the measurement model for the group of contracts. The CSM is a component of the insurance contract liability for a group.

The CSM is measured at initial recognition for a group as the excess (if any) of the expected present value of cash inflows over cash outflows within the boundary of the contract (including acquisition costs) after adjustment for non-financial risk.

If outflows at initial recognition are greater than inflows, the group is onerous, no CSM is established, and a loss component is calculated at the time of initial recognition. The loss component is recognised immediately, while the CSM is recognised gradually over time in line with the services provided.

Thereafter, the CSM is rolled forward with interest accrual, adjustments for some experience items, changes in estimates of future cash flows, and allowance for the risk adjustment for non-financial risk, dependent on the measurement model adopted. The CSM is then released as part of insurance service revenue based on coverage units representing the service provided in the period and services expected to be provided in the future.

This means that while the initial determination of the CSM for the group is a prospective calculation, thereafter it is primarily a retrospective calculation or roll forward (i.e., the retrospectively calculated CSM value is adjusted based on the relevant new information and released in line with the services provided).

The CSM reflects the IASB's view that profit on insurance contracts should only be recognised as service is provided, which is consistent with IFRS 15 *Revenue from Contracts with Customers*, and not on the day of policy sale (see paragraphs IN7 and BC18).

Measurement on Initial Recognition

6.2. How is the CSM determined at initial recognition?

The CSM for a contract is established at initial recognition to offset any profit that may arise from simply considering the fulfilment cash flows. The fulfilment cash flows include expected future cash outflows and inflows as well as the risk adjustment for non-financial risk. At initial recognition, the CSM considers all contractual cash flows within the contract boundary.

In the case of a profitable contract, the outcome of measuring the present value (at inception) of all cash flows should be negative (total cash outflows minus total cash inflows), which would result in a negative liability (or asset). This negative liability is eliminated at contract inception by the creation of the CSM as an additional component of the liability of the group to increase the total liability to zero. However, pre-coverage cash flows can impact the amount actually recognised on the balance sheet (see question 6.3). The outcome in the case of an unprofitable contract is discussed in question 6.4.

Other than in the case of reinsurance held, the CSM is subject to a minimum of zero. For the CSM for reinsurance held, see question 6.32.

There is no difference in the calculation of the CSM at inception for contracts without direct participation features and those with direct participation features. For information about subsequent measurement of the CSM for insurance contracts with direct participation features, see question 6.22.

The CSM at initial recognition and subsequently may be determined at the level of the group.

6.3. What are pre-coverage cash flows?

Paragraph 25 states that the recognition date of the contract is the earliest of the following:

a) the beginning of the coverage period of the group of contracts;
b) the date when the first payment from a policyholder in the group becomes due; and
c) *for a group of onerous contracts, when the group becomes onerous*.

Pre-recognition cash flows include contractual cash flows relating to the group that were paid or received by the entity before the recognition date of the group. The recognition date determines which cash flows are pre-recognition and which are not. Examples of pre-coverage cash flows may include:

- Premiums under the contract;

- Commissions spent due to contractual obligations with an intermediary in response to writing the contract; and
- Costs meeting the definition of "insurance acquisition cash flows" arising during the application and underwriting process (i.e., underwriting costs) and issuance cost.

Pre-coverage cash flows include any insurance acquisition cash flows for which an asset or liability is held prior to the recognition of the group that gave rise to them (see paragraph 38(c)). Further, pre-coverage cash flows include cash flows that are directly and indirectly allocated to a contract (e.g., acquisition cost spent without success) provided they are directly attributable at a portfolio level.

6.4. Can the CSM be negative at initial recognition?

Except in the case of reinsurance held (see Chapter 9 – Reinsurance), the CSM cannot be negative, and when the calculation indicates a negative value, the CSM is instead set to zero. This results in a loss being reported equal to the amount by which the CSM otherwise would have been negative.

The negative balance is referred to as the loss component (see questions 6.27 to 6.31 on onerous contracts).

Subsequent Measurement: Contracts without Direct Participation Features

6.5. What changes are recognised in the CSM for contracts without direct participating features?

Paragraph 44 outlines how the CSM for a group without direct participating features moves over time. It is presented as follows:

CSM at the start of the reporting period

plus the effect of any new contracts added to the group (see question 6.6);

plus the value of interest accretion (see question 6.7);

plus the changes in fulfilment cash flows relating to future service (see questions 6.8 – 6.11);

plus the value of currency exchange differences;

less the amount recognised as insurance revenue because of the transfer of services (see questions 6.12 – 6.21)

= CSM at end of the reporting period.

Alternative presentations are possible, and there is no prescribed calculation order other than the amortization of the CSM for services over the period, which is the last step.

6.6. When can new contracts be added to a group?

Only contracts recognised during the reporting period can be added to a group during that reporting period. In accordance with paragraph 28, new contracts can be added to

the group after the end of the reporting period (subject to all contracts in the group being issued no more than one year apart, see paragraph 22).

6.7. What interest rate is accreted on the CSM?

If the general measurement approach ("GMA") is used, interest is accreted on the carrying amount of the CSM during the reporting period using the discount rates applied on initial recognition to reflect the time value of money (paragraphs 44(b) and B72(b)). These discount rates are applied to nominal cash flows that do not vary based on the returns of any underlying items. For further details on determining discount rates, see Chapter 3 – Discount Rates.

6.8. Which changes in fulfilment cash flows qualify for adjusting the CSM?

Paragraph 44(c) states that the CSM is adjusted for:

> *the changes in fulfilment cash flows relating to future service as specified in paragraphs B96–B100, except to the extent that:*
>
> *i. such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or*
>
> *ii. such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b)".*

Table 6.1 summarises which components underlying the fulfilment cash flows qualify for adjusting the CSM for contracts without direct participation features.

Table 6.1: Which changes in fulfilment cash flows qualify for adjusting the CSM?

Item	Adjust CSM?
The effect of any new contracts added to the group (paragraph 44(a))	Yes
Change in present value of cash flows related to future coverage and other services due to:	
Experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the locked-in discount rates (paragraph B96(a))	Yes
Changes in estimates of the present value of the future cash flows in the liability for remaining coverage (e.g., due to either assumption changes or differences in number or characteristics of contracts in force at measurement date from that expected), measured at the locked-in discount rate (paragraph B96(b))	Yes
Differences between the actual and expected investment component paid in the period, measured at the locked-in discount rate (paragraph B96(c))	Yes
Changes in the data information affecting the risks of the policyholder	Yes
Change in risk adjustment for non-financial risks that relate to future service (paragraph B96(d))	Yes
Change in estimates that do not relate to future service:	
Change in the time value of money and financial risks (paragraph B97(a))	No
Change in estimates of fulfilment cash flows in the liability for incurred claims (paragraph B97(b))	No
Experience adjustments[24] on current period cash flows except those described above (paragraph B97(c))	No

Note that paragraph 67 specifies that changes to fulfilment cash flows that result from changes in the risk of non-performance by the issuer of a reinsurance contract held do not relate to future service and therefore do not adjust the CSM

[24] Experience adjustments as defined in IFRS 17, Appendix A.

6.9. What is the difference between the expected and actual investment component payable in the period that adjusts the CSM?

If, due to actual experience differing from expected experience, an investment component of the contract (i.e., an amount to be repaid to the policyholder under all circumstances) that was expected to be repaid in the current period is not repaid, then it will be paid at some time in the future. As this repayment was not originally included in the estimate of future cash flows, the estimate is increased by the present value of the future repayment at a later estimated repayment date.

Per paragraph B96(c), a change in the estimate of such future cash flows adjusts the CSM (i.e., decreases the CSM by the present value of the future repayment of the investment component) applying the locked-in rate according to paragraph B72(c).

The CSM is adjusted for difference between actual and expected investment components during the period at the locked-in discount rate (paragraph B96(c)).

The opposite bookings apply if an investment component is repaid in the current period and it was expected to be repaid in a future period.

6.10. How are changes in the risk adjustment for non-financial risk reflected in the CSM?

The CSM should be adjusted for changes in the risk adjustment for non-financial risk relating to services provided in future periods (paragraph B96(d)), subject to the condition that the CSM should not be negative. Changes in the risk adjustment for non-financial risk relating to coverage and other services provided in the current or past periods should be recognised as insurance revenue.

The entity can disaggregate the change in risk adjustment for non-financial risk between the insurance service result and insurance finance income or expenses (paragraph 81). If the entity does not disaggregate in this way, then the entire change in risk adjustment is disclosed as part of the insurance service result.

6.11. Does a change in the discretionary cash flows paid to policyholders during the reporting period for an insurance contract without direct participation features change the CSM?

Yes, if the entity has discretion over the cash flows to be paid to policyholders for insurance contracts without direct participation features, then a change in the discretionary cash flows is regarded as relating to future service and adjusts the CSM (paragraph B98).

To determine how to identify a change in discretionary cash flows, see paragraphs B98-B100.

Transfer of Services

6.12. How is the transfer of services determined?

The amount of the CSM recognised as insurance revenue for a group in each period reflects the services provided under the group in that period (see paragraphs 44(e), 45(e), 66(e), and B119).

The entity allocates the CSM at the end of the period equally to each coverage unit provided in the current period and those expected to be provided in the future within the contract boundary and recognises in profit or loss the amount allocated to the coverage units provided in the current period (see question 6.13).

6.13. Does the transfer of the service in the reporting period (revenue) include the estimate changes done at the end of the period or do the changes impact only to the future periods?

The transfer of the services in the reporting period includes the estimated changes made at the end of the period. The CSM at the start of the reporting period is adjusted for the changes in estimates of the present value of the future cash flows (paragraphs 44(c) and B96(b)) and the amount recognised as insurance revenue because of the transfer of services in the period. The amount is determined by allocating the CSM at the end of the period (before recognising any amounts in profit or loss to reflect the services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future (paragraphs 44(e) and B119(b)). Refer also to paragraphs BC221 and BC224(e).

6.14. What is a coverage unit?

The coverage units establish the amount of the CSM to be recognised in profit or loss for services provided in the period. Coverage units reflect "the quantity of the benefits provided under a contract and its expected coverage duration" (paragraph B119(a)).

Aspects of IFRS 17 relevant in interpreting coverage unit include the coverage period and the insurance contract services, which are defined in Appendix A

Coverage period: *The period during which the entity provides insurance contract services. This period includes the insurance contracts services coverage that relates to all premiums within the boundary of the insurance contract.*

Insurance contract services: *The following services that an entity provides to a policyholder of an insurance contract:*

(a) coverage for an insured event (insurance coverage);

(b) for insurance contracts without direct participation features, the generation of an investment return for the policyholder, if applicable (investment-return service); and

(c) for insurance contracts with direct participation features, the management of underlying items on behalf of the policyholder (investment-related service).

I**nsured event**: *An uncertain future event covered by an insurance contract that creates insurance risk.*

The application guidance (included within paragraphs B7- B32) discusses what constitutes insurance risk.

The recognition of the CSM in insurance revenue is related to the transfer of insurance contract services (paragraphs 44 and 45). Paragraph 44(e) states:

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

Paragraphs BC279 to BC283 set out the IASB's rationale for the release of the CSM and the use of coverage units for this purpose. In particular, the following were discussed and rejected by the IASB as the basis for release of the CSM:

a) pattern of expected cash flows (BC279(a));

b) the change in the risk adjustment for non-financial risk caused by the release from risk (BC279(a));

c) when the returns on investment components occur even where this drives total expected fee (BC280).

A discussion about how to determine the quantity of benefits in an insurance contract when determining the coverage units of a group was initially discussed at the February 2018 TRG meeting (paper AP05) and considered further and in more depth at the May 2018 TRG meeting (paper AP05 and TRG Meeting Summary). It was observed that:

> *IFRS 17 established principles, not detailed requirements, and detailed requirements would not work appropriately in all cases;*
>
> *determination of coverage units is not an accounting policy choice, but requires application of careful judgement and consideration of the facts and circumstances to best achieve the principle of reflecting the services provided in each period;*
>
> *the analysis of the examples discussed at the May 2018 meeting reflects the fact pattern of each example and does not necessarily apply to other fact patterns;*

In considering how to achieve the principle, TRG members observed that:

a) lapse expectations are included to the extent they affect expected duration of coverage;

b) the different levels of service across periods needs to be reflected in determination of coverage units;

c) the quantity of benefits is determined from the policyholder perspective and not the quantity of benefits expected to be incurred by the insurer;

d) a policyholder benefits from the insurer standing ready to meet valid claims should the insured event occur, hence the quantity of benefits relates to amounts that can potentially be claimed;

e) different probabilities of insured events across periods do not of themselves affect the stand-ready quantity of benefit provided to a policyholder, but where there are

different types of insured events, their different probabilities might affect the stand-ready benefit provided by the insurer; and

f) IFRS 17 does not specify particular method(s), and thus different methods may achieve the objective of reflecting the service provide in each period.

6.15. What service should be reflected in coverage units?

For contracts with direct participation features,

coverage units should be determined based on both insurance and investment related services (see paragraph B119). For contracts that are measured using the variable fee approach ("VFA"), coverage units used to amortise the CSM should be determined by considering the quantity of benefits and timing of both insurance coverage and investment-related services.

Similarly, for contracts without direct participation features that provide an investment-return service, coverage units should be determined by considering the quantity of benefits and expected period of both insurance coverage and any investment-return service. For such contracts without direct participation features, an investment-return service may exist if, and only if (see paragraph B119B):

- an investment component exists, or the policyholder has a right to withdraw an amount;
- the entity expects the investment component or amount the policyholder has a right to withdraw to include an investment return; and
- the entity expects to perform investment activity to generate that investment return.

Are there examples available of coverage units?

The appendices of the IASB's May 2018 TRG paper AP05 contain a large number of examples, and the paper contains the IASB staff's analysis of potential views of what coverage unit means in the context of specific facts and circumstances. These might be helpful in aiding understanding but only in the context of the specific set of facts and circumstances outlined in the paper. Included in Appendix B of the May 2018 TRG paper AP05 are thirteen examples covering the following products:

- Credit life loan insurance;
- Credit life product with variable amount of cover;
- Mortgage loss cover;
- Product warranty;
- Extended product warranty;
- Health cover;
- Proportional reinsurance issued;
- Reinsurance adverse development of claims with claim limit;

- Reinsurance adverse development of claims without claim limit;
- Transaction liability;
- Combination of different types of cover;
- Life contingent annuity; and
- Forward purchase of fixed rate annuity.

6.16. Which proxies (e.g., premium and passage of time) can be used as coverage units?

Depending on the facts and circumstances, the following methods (which are not an exhaustive list) might be reasonable proxies:

(i) Allocation over time but reflecting the expected coverage duration of contracts within the group;

(ii) Use of maximum contract cover in each period;

(iii) Use of cover amounts for which the policyholder could validly claim each period should insured event occur;

(iv) Use of premiums, but not if they:

a) Are receivable in different periods to the insurance services;

b) Reflect different probabilities of claim for the same insured event in different periods rather than different levels of stand-ready service; or

c) Display different levels of profitability in contracts rather than the stand-ready service.

6.17. How do you deal with multiple benefits on a single contract?

Alternative approaches that may be helpful when dealing with multiple benefits on a single contract include but are not limited to:

- Consider whether the contracts can be separated into components for the purposes of measurement (note the TRG covered considerations relating to the separation of insurance components during its February 2018 meeting);
- Determine coverage units based on the individual benefit components separately and adjust the CSM according to the recognition of all relevant coverage units during the period; and
- Consider whether a coverage unit reflecting the characteristics of all benefits can be determined.

6.18. Can coverage units be calculated net of reinsurance?

No. As underlying business and reinsurance are valued and reported separately, coverage units need to be determined gross rather than net. Coverage units for any related reinsurance treaties would be determined separately in respect of the reinsured amount for the treaties (paragraph 66).

6.19. When does the coverage period start and end?

See question 6.14 for the definition of coverage period. Coverage would normally start at the effective date of the insurance contract. In some circumstances, coverage may:

- Start later (e.g., for travel insurance, coverage may only start from the date of travel); or
- Appear to start earlier (e.g., a reinsurance treaty may provide cover on a claims-notified basis, such as for the emergence of claims not yet reported to the cedant but arising prior to the start date). In this reinsurance example, however, coverage of notified claims only starts from the start date of the reinsurance contract.

Normally, coverage will cease at the end date specified in the contract or the contract boundary, if earlier, or upon a valid claim arising before the end date for many types of life insurance contracts. Depending on the nature of the contract, claims arising from events occurring after that time may not give rise to a valid claim under the contract. Note that notification or settlement of the claim may occur after the end date, and the claim amount ultimately payable may continue to develop after the end of the coverage period. The notification, development, and ultimate settlement may be part of the liability for incurred claims and do not represent the provision of further coverage, or they can be the continuation of the coverage period as in the life-contingent annuities (see paragraph B5 and TRG September 2018 meeting AP1).

Unlike some types of insurance where a sequence of independent events might trigger the incurrence of a claim, for stop loss reinsurance, it is the occurrence of underlying claims for an amount that in total triggers a stop loss claim. With stop loss reinsurance, coverage is for claim payments arising in excess of the stop loss attachment point, and coverage starts from the point at which a valid claim could be made under the contract and not the underlying individual events.

Subsequent events may change the amount of the ultimate claim payable, but such events represent development of the claim amount and not the provision of further cover. For example, an accident may cause a disability that gives rise to the payment of an annuity for the remaining life of the person disabled. In this example, one view is that the coverage is for the occurrence of an event that causes such disablement. Others believe that the coverage is the ongoing condition requiring further payments. The TRG noted that contract styling and judgment might determine which view is most appropriate.

6.20. Can the coverage units include discounting?

Yes, coverage units can include the impact of the time value of money.

IFRS 17 is silent on whether the time value of money needs to be allowed for in determining the release pattern for the CSM, and if so, what discount rate is to be used for the coverage unit. Paragraph BC282 makes it clear that this has been deliberately left to the discretion of the entity.

An example of discounting and not discounting coverage units is provided in IFRS 17 Illustrative Example 2, IE17(e).

Subsequent Measurement: Contracts with Direct Participating Features

(also refer to Chapter 8 – Contracts with Participation Features and Other Variable Cash Flows)

6.21. How does subsequent measurement of the CSM differ for insurance contracts with direct participating features?

For insurance contracts with direct participation features, the entity provides insurance and investment related services and is compensated for the services by a fee that is determined with reference to the underlying items. The CSM is subsequently measured similarly as for contracts without direct participating features (see question 6.5) except in relation to:

1 the entity's share of the change in the fair value of the underlying items (see question 6.22);

2 the interest rate accreted to the CSM (see questions 6.23 and 6.24); and

3 any financial risk mitigation (see question 6.25).

The amounts that adjust the CSM do not need to be identified separately. For example, entities need not identify the adjustments to the CSM for changes in the entity's share of the change in the fair value of underlying items separately from those related to changes to the fulfilment cash flows related to future services. A combined amount can be identified for some or all of them (paragraph 45).

Please also see the answer to question 8.12.

6.22. How do changes in the fair value of underlying items impact the CSM?

Changes related to the entity's share of the fair value of the underlying items (i.e., the variable fee) relate to future service and adjust the CSM except to the extent that:

- the entity meets the conditions for the financial risk mitigation option and chooses to adopt it;
- the entity's share of a decrease in the fair value of the underlying items exceeds the carrying amount of the CSM, giving rise to a loss; or
- the entity's share of an increase in the fair value of the underlying items reverses losses previously recognised.

6.23. Is the CSM adjusted for changes in the effect of the time value of money and financial risks not arising from the underlying items?

Changes in fulfilment cash flows arising from the time value of money and financial risks are regarded as part of the variable fee and recognised in the CSM unless the changes exceed the CSM or the risk mitigation option is taken (see paragraph B115 – B118).

6.24. Which discount rates is used to calculate the CSM?

No explicit interest is accreted on the CSM as the CSM is re-measured when adjusted for changes in the entity's share of the underlying items.

6.25. What is required to use and the implications of using the financial risk mitigation option?

Paragraphs B115 and B116 provide an option for an entity to reduce an accounting mismatch between the measurement of derivatives, non-derivative financial instruments at fair value through profit or loss, or reinsurance contracts held to mitigate financial risk and the insurance liability. Derivatives are generally measured under IFRS 9 at fair value through profit or loss. For direct participation contracts, changes in the carrying amount of the fulfilment cash flows related to financial risks adjust the CSM instead of being recognised immediately in profit or loss regardless of whether they relate to the entity's share of the underlying items.

An entity can choose to apply the option of not adjusting the CSM for some changes in the fair value of underlying items (paragraph 45(b)(i)) or the fulfilment cash flows relating to future service (paragraph 45(c)(i)) if it uses derivatives, non-derivative financial instruments at fair value through profit or loss, or reinsurance contracts held to mitigate the financial risk arising from the insurance contracts, and paragraph B115 applies.

For contracts without direct participation, such an accounting mismatch does not arise as changes in the carrying amount of the fulfilment cash flows related to financial risks do not adjust the CSM.

Onerous Contracts

6.26. What is an onerous group and how are they treated in profit or loss?

A group is considered onerous if the CSM would otherwise be negative (i.e., there are future losses expected on the group after including allowance for the risk adjustment for non-financial risk). This can occur at the outset or occur on subsequent measurement if the following amounts exceed the CSM:

(a) unfavourable changes in the fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service; and

(b) for a group with direct participation features, the entity's share of a decrease in the fair value of the underlying items.

The amount by which the group is onerous is recognised immediately as a loss when it is known that it is loss making (paragraph 25).

6.27. When are onerous contracts recognised?

A group of onerous contracts needs to be recognised when the group is identified as being onerous, even if this is before coverage has commenced or the first premium is due though not before the contract is issued (paragraph 25).

6.28. What is a loss component?

The loss component at initial recognition represents the expected amount of future obligations not covered by future expected cash inflows on a risk-adjusted present value basis applying the locked-in discount rate as applied for adjusting the CSM. Any change,

particularly any fulfilment of that part of the future obligations, is not presented as insurance revenue, as insurance revenue can arise only from premiums. Changes in the loss component are recognised as positive or negative insurance service expenses (i.e., reversal of the loss component, see paragraphs 49 and 103(b)(iv)).

6.29. How is the loss component tracked over time?

The loss component is tracked and adjusted over time for further losses and loss reversals by allocating any changes in the fulfilment cash flows due to changes in estimates of future cash flows relating to future service, which if:

i) Unfavourable, increase the loss component and give rise to a further loss; or

ii) Favourable, reduce the loss component, give rise to loss reversal and re-establishment of the CSM once the loss component is extinguished.

The remaining change in the fulfilment cash flow of the group is allocated on a systematic basis between the loss component and the balance of the liability for remaining coverage (paragraphs 50(a)). According to paragraph 51:

The subsequent changes in the fulfilment cash flows of the liability for remaining coverage to be allocated applying paragraph 50(a) are

i) estimates of the present value of future cash flows for claims and expenses released from the liability for remaining coverage because of incurred insurance service expenses;

ii) changes in the risk adjustment for non-financial risk recognised in the profit or loss because of release from risk; and

iii) insurance finance income or expenses.

The systematic basis used needs to ensure that the loss component is extinguished by the end of the coverage period of the group (paragraph 52). Examples of how this can be done include but are not limited to:

- the same release method that would have been applied to the group if there had been a CSM (e.g., coverage); and
- the opening balance of the loss component as a percentage of the future cash flows and the risk adjustment for financial risk relating to future service (see Illustrative Example 8).

6.30. How are onerous contracts dealt with if they are acquired through a transfer of business?

Paragraph B95A outlines that the amount identified as being onerous is either classified as goodwill or gain on a bargain purchase for contracts acquired in a business combination within the scope of IFRS 3 or as a loss in profit or loss for contracts acquired in a transfer.

Reinsurance Contracts Held

6.31. How is the CSM determined at initial recognition for reinsurance held?

A CSM is determined for a reinsurance held contract at initial recognition using the same approach as for any direct contract, and the concept of an onerous reinsurance held contract does not exist (paragraph 68). This difference means that at initial recognition the CSM can either:

a. reduce the reinsurance held asset (where the present value of reimbursements from the reinsurance contract exceeds the present value of reinsurance premiums) and therefore defer recognition of profit from the reinsurance contract; or

b. increase the reinsurance held asset (where the present value of reinsurance premiums exceeds the present value of reimbursements from the reinsurance contract) and therefore defer recognition of losses from the reinsurance contract (see paragraph 65(a)).

The following table shows the measurement of a reinsurance contract where the CSM is negative (referred to as Scenario 1, where this is a net cost of purchasing reinsurance) versus when the CSM is positive (referred to as Scenario 2, where there is a net gain of purchasing reinsurance). Both scenarios assume that the risk of non-performance of the reinsurer is negligible.

Table 6.2: Illustrative example of the CSM for a Reinsurance Contract

	Scenario 1	Scenario 2
Present value of cash inflows (recoveries)	(500)	(500)
Present value of cash outflows (premiums paid)	750	450
Risk adjustment for non-financial risk	(50)	(50)
Fulfilment cash flows	200	(100)
CSM	(200)	100
Reinsurance contract asset on initial recognition	-	-

6.32. At initial recognition, does the existence of reinsurance held impact the determination of the CSM and onerous contract testing of the gross policy liabilities?

No, because key principles of IFRS 17 (paragraph B66(b)) are to separately recognise the underlying gross liabilities from any associated reinsurance held, determination of a CSM, and onerous contract testing of the direct contract liabilities. A loss is recognised on the initial recognition of the direct contract liabilities if they are an onerous group of

insurance contracts, while a gain is recognised on the reinsurance held covering those underlying contracts (see paragraphs 66A and 66B). In recognising this gain called "loss recovery component", the entity adjusts the CSM of the group of reinsurance contracts held. This is only applicable when the reinsurance contract held is recognised before, or at the same time as, the loss on the underlying direct contracts is recognised. If a reinsurance contract held is accounted for under the PAA, the same general approach is applied, however, the adjustments are made to the asset for remaining coverage rather than the CSM as the PAA does not have a CSM component (paragraphs 70A and 66c(ii)).

The loss recovery component should be treated in a manner consistent with the loss component of the group of underlying insurance contracts issued.

6.33. How is the CSM on reinsurance held determined at subsequent measurement?

The subsequent measurement of the CSM for reinsurance held accounted for under the GMA is performed in the same way as for direct contracts, except when the underlying gross contract(s) becomes onerous (or is already onerous and becomes more or less so) due to changes in fulfilment cash flows relating to future service. In such circumstances, the change in fulfilment cash flows for the reinsurance held also does not adjust the CSM of the reinsurance held under paragraph 66(c)(ii).

The requirement under paragraph 66(c) is that changes in reinsurance fulfilment cash flows resulting from a change in fulfilment cash flows relating to future service will not adjust the reinsurance CSM if the change does not adjust the CSM on the underlying group of contracts. This is the case if the underlying group of contracts is onerous.

In these circumstances, it is possible that the offsetting impact on the reinsurance held may exceed that on the underlying contracts due to accounting mismatches that could arise between the reinsurance and the underlying contracts (e.g., due to different contract boundaries or measurement approaches).

6.34. How is the reinsurance CSM adjusted when the change in reinsurance fulfilment cash flows relates to an underlying group using PAA?

When the gross liability for remaining coverage is determined using the PAA, there are different views for how to apply paragraph 66(c). Two such views are outlined below.

According to view A, only when the underlying group is onerous is the reinsurance CSM not adjusted. The argument for view A is as follows:

i. This is consistent with the rationale given by the IASB that where an underlying group becomes onerous due to changes in estimates for future service then the reinsurance CSM should not be adjusted, creating an offset (BC315);

ii. Estimates for future service only occur under the PAA when the group is onerous (see paragraphs 57-58); and

iii. Criteria for not adjusting reinsurance CSM under paragraph 66(c) are that there is a change in underlying fulfilment cash flows for future service that does not adjust the CSM of the underlying group. Such change only occurs under the PAA when

contracts are onerous, as otherwise underlying fulfilment cash flows are not measured under the PAA.

According to view B, the reinsurance CSM is never adjusted when the change in reinsurance fulfilment cash flows relates to an underlying group using the PAA even when the underlying cash flows are not onerous because:

i. there is no CSM under PAA, and thus any change to reinsurance cash flows relating to underlying group does not adjust the CSM of the underlying; and

ii. the criteria in paragraph 66(c) do not require an actual change in fulfilment cash flows for the underlying group. Rather, it requires a change in the fulfilment cash flows of the reinsurance contract relating to the underlying group and does not change the CSM of the underlying group.

6.35. How is the grouping for the CSM impacted by the fact that reinsurance contracts may cover multiple years of underlying policies?

IFRS 17 prohibits grouping contracts issued more than one year apart. Reinsurance contracts held are aggregated differently from the underlying contracts (paragraph 61).

In particular, reinsurance contracts are treated as a separate portfolio from the underlying and are grouped based on the characteristics and inception dates of the reinsurance contract, not the underlying contracts.

The grouping of reinsurance contracts will require careful consideration when matching which adjustments to the CSM are restricted, as there may be multiple underlying groups and no one-to-one correspondence between contracts or benefits reinsured.

Other Issues

6.36. How is the CSM calculated for business combinations and transfers of insurance contracts at initial recognition?

Unless the PAA for the liability for remaining coverage applies, on initial recognition, the CSM is calculated applying paragraph 38 for acquired insurance contracts in a transfer or in a business combination within the scope of IFRS 3 and paragraph 65 for acquired reinsurance contracts held using the consideration received or paid for the contracts as a proxy for the premiums received or paid at the date of initial recognition.

If acquired insurance contracts issued are onerous, applying paragraph 47, the entity should recognise the excess of the fulfilment cash flows over the consideration paid or received as part of goodwill or gain on a bargain purchase for contracts acquired in a business combination within the scope of IFRS 3 or as a loss in profit or loss for contracts acquired in a transfer. The entity should establish a loss component of the liability for remaining coverage for that excess, and apply paragraphs 49 to 52 to allocate subsequent changes in fulfilment cash flows to that loss component.

See Chapter 11 – Business Combinations and Portfolio Transfers for a further discussion.

6.37. How is the CSM calculated at transition?

The measurement of the CSM or loss component under the full retrospective, modified retrospective, and fair value approaches at transition is discussed in Chapter 12 – Transition.

6.38. What needs to be presented?

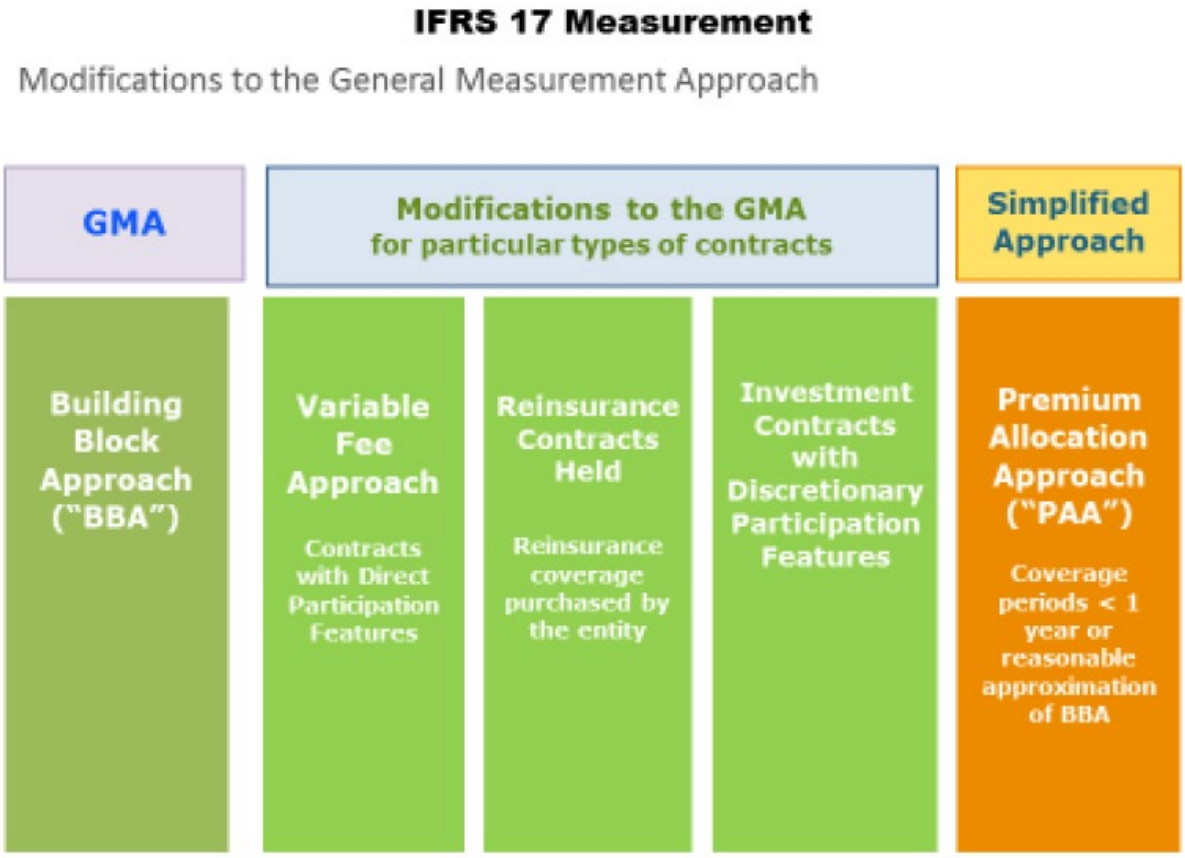
For contracts with direct participation features, if an entity chooses to adopt the financial risk mitigation option (see question 6.25), then the entity discloses the effect of that choice on the adjustment to the CSM that would otherwise have been made in the current period (paragraph B112).

See Section E - Presentation and Disclosure for a discussion on what to present relating to the CSM.

Section B – Variations to the General Measurement Approach

This section includes three chapters that cover the variations to the General Measurement Approach (GMA). These are:

- The Premium Allocation Approach – Chapter 7
- Contracts with Participation Features and Other Variable Cash Flows – Chapter 8
- Reinsurance Contracts Held – Chapter 9



As discussed in Chapter 7 the PAA may be used whenever it provides a good approximation to the GMA liability for remaining coverage. It may also be used for groups of contracts with a coverage period of one year or less, regardless of whether it provides a good approximation. Many non-life insurance contracts satisfy this criterion. However, longer-term annual renewable contracts may also satisfy this criterion, if the contract boundary lies at the next renewal date.

As discussed in Chapter 8, the circumstances as to when the VFA may be used are not always straightforward especially for contracts with direct participation features which may well vary by jurisdictions. Although not insurance contracts, Investment Contracts with Discretionary Participation Features are in scope of IFRS 17 "provided they are issued by an entity that also

issues insurance contracts". If so, these contracts are measured in the same was as Contracts with Direct Participation Features.

Whilst reinsurance contracts issued by an Insurer / Reinsurer are accounted for using the GMA, there are variations as to how an entity accounts for reinsurance held. This is discussed in Chapter 9.

Chapter 7 – Premium Allocation Approach

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

7.A. What does this chapter address?

This Chapter considers the use of the Premium Allocation Approach (PAA) under IFRS17 including the criteria applying to an insurance contract which must be met for an entity to be able to choose the PAA, the measurement approach, and the differences between the PAA and the General Measurement Approach (GMA). The chapter focuses on the "*liability for remaining coverage*", where most of the differences between the PAA and the GMA are found, although minor differences for the "*liability for incurred claims*" are discussed. See also Section E – Presentation, and Disclosure.

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

Paragraphs 18, 53–59, 69–70, 72(c), B72(d), B72(e)(iii), B126–B127, and B133 provide guidance.

Paragraphs BC288–BC295 and BC301 also provide background on this topic.

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

None

7.1. What is the premium allocation approach?

The PAA, which is set out in paragraphs 53-59, is a simplification of the GMA basis described in paragraphs 32–52. The IASB stated that there is only one model, the GMA, for measuring insurance contracts. Paragraph 53 states that an entity may use the PAA to measure the liability for remaining coverage only if it reasonably expects that the PAA would produce a measurement for a group of insurance contracts ("group" that would not differ materially from the one that would be produced applying the GMA or if the coverage period of each contract in the group is one year or less. (See question 7.2).

The PAA primarily applies to the liability for remaining coverage, the obligation that relates to the unexpired portion of the coverage period. The liability for incurred claims is measured under the GMA, which is discussed in Chapters 2 through 6, as modified by paragraph 59(b). (See question 7.13.)

The remainder of this chapter considers questions relevant to when and how the PAA may be used. In particular, see questions 7.10 and 7.11 for more information on the subsequent measurement of the liability for remaining coverage under the PAA.

7.2. When might an entity choose to use the PAA?

Whilst the PAA represents a simplification of the GMA, when an entity decides to implement the PAA will depend on the circumstances of each entity. For example, an entity may prefer to use the PAA where it can be implemented with fewer practical changes to existing systems and processes than might be required to develop an

approach to measurement and reporting of the CSM under the GMA. If not all of an entity's contracts are eligible for the PAA, then that entity may need to consider whether there are benefits to implementing the PAA for eligible contracts and developing an alternative approach to implementing the GMA for other contracts or whether to implement the GMA for all contracts.

The PAA may allow more straightforward reporting of the groups to which it is applied than the GMA. Again, the entity may want to consider this fact from the perspective of the transparency of information provided to users and in the context of the information provided if the GMA is applied to other groups.

The PAA is similar to the unearned premium approach used by many entities for reporting unexpired coverage under IFRS 4, local GAAP and / or regulatory reporting for short duration contracts. However, the PAA is not the same as some unearned premium (UEP) approaches, and adjustments may be required. One of the most important differences is that the PAA is net of acquisition expenses (unless the option in 59(a) is applied), while UEP approaches are typically gross of acquisition expenses (with an offsetting Deferred Acquisition Cost Asset). Another difference is that the PAA uses received premiums, while UEP approaches typically use written premiums. This may mean that the liability for remaining coverage under IFRS 17 will be lower than UEP measures under IFRS 4. (See question 7.9.)

Considerations for entities in deciding whether to use the PAA might include, for example, the extent to which existing and potential future contracts are eligible for the PAA, the extent to which existing systems and processes support reporting the PAA for eligible contracts, and the additional resources and costs that may be required to implement the GMA compared with PAA.

7.3. What are portfolios of insurance contracts ("portfolios") and groups of insurance contracts ("groups")?

Portfolios and groups, which are both defined terms in Appendix A of IFRS 17, are related to the level of aggregation and important in decision-making about the use of the PAA. See Chapter 1 – Classification of Contracts and Chapter 5 – Level of Aggregation.

7.4. When can the PAA be applied?

The PAA can be applied if the conditions in paragraph 53 are met. Paragraph 53 states:

An entity may simplify the measurement of a group of insurance contracts using the premium allocation approach set out in paragraphs 55–59 if, and only if, at the inception of the group:

a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the requirements in paragraphs 32–52; or

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

While the PAA is primarily for groups of short-duration contracts, it is allowed whenever it provides a materially equivalent measure (in this chapter, referred to as a "reasonable approximation") to the GMA liability for remaining coverage (paragraph 53(a)). The use of the PAA is, however, qualified by paragraph 54 (see question 7.5).

Paragraph 53(b) allows the PAA to be used for groups with a coverage period of one year or less regardless of whether the PAA provides a reasonable approximation. The length of the coverage period depends on the contract boundary (see question 7.8). Many non-life insurance contracts satisfy this criterion. Longer-term annual renewable contracts may also satisfy this criterion if the contract boundary lies at the next renewal date.

Use of the PAA is optional for an entity. The GMA can always be used even where the PAA is allowed. The PAA was introduced mainly to provide a simplified approach for non-life insurance contracts and short-duration contracts more generally. The PAA might be suitable for many single premium contracts (e.g., personal motor insurance and group health insurance) and may also be suitable for regular-premium contracts (e.g., annual renewable term life insurance) provided each premium is commensurate with the risk for the corresponding period of coverage. For more complex contracts, the PAA may not prove simpler in application than the GMA, particularly if the time value of money is allowed for.

Another consideration for the use of the PAA is consistency. In order to use the PAA for as many contracts as possible, an entity writing non-life insurance contracts may choose to conduct additional testing to determine if the PAA can approximate the GMA. There may be advantages for an entity to use consistent reporting of its whole business and remove the additional burdens of measurement under the GMA in the pre-claims period (such as the CSM and the more detailed disclosure requirements of the GMA). Conversely, an entity writing life insurance contracts may prefer to use the GMA rather than the PAA, even for simpler contracts, for consistency with how most of its contracts will be measured and presented.

Use of the PAA is an accounting policy choice and therefore subject to IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors if the entity decides to change from the PAA to the GMA (or vice versa) for eligible groups.

7.5. When is the PAA not allowed?

The PAA cannot be applied in circumstances outlined in paragraph 54, which states:

> *The criterion in paragraph 53(a) is not met if at the inception of the group an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:*

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

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

The PAA may have a greater risk of not producing a reasonable approximation to the GMA for groups whose coverage period is greater than one year. The following table provides a non-exhaustive list of examples where the PAA might not provide a reasonable approximation of the GMA.

Scenario	**Reasoning**
Patterns of the expected incurred claim costs and the release of the risk adjustment for non-financial risk are significantly different from each other during the coverage period.	The PAA reduces the liability for remaining coverage in line with the pattern of insurance service expenses, while the GMA considers the impact of both in the relevant building blocks potentially leading to significant differences in the value of the liability for remaining coverage under the PAA versus the GMA over the coverage period.
The pattern of expected incurred claim costs is highly uneven, and the CSM is significant under the GMA.	The CSM under the GMA is released in accordance with the insurance service provided, which is based on coverage units for the duration of coverage. If the coverage provided by a contract is the same over the coverage period, then the CSM would be expected to be amortised evenly for each coverage period. For the PAA, an uneven pattern of expected incurred claims would result in an uneven pattern of premium allocated to each period. The size of the CSM would then determine the significance of this difference.
The longer the expected payout pattern is for the coverage and/or the higher the interest rate environment.	Significant variability in the cash flows may occur during the coverage period if the time value of money is a major component of the underlying building blocks of the GMA. For long payout patterns, even a small change in a low interest rate environment could significantly change the value of the liability for remaining coverage for the GMA. In a high interest rate environment, interest rates tend to be more volatile, and discount can be a significant portion of the liability for remaining coverage

	even for shorter tailed non-life insurance business.
In a high interest rate environment where there is no significant financing component and the premium is due within a year of providing the relevant coverage.	In this situation, an entity is not required under the PAA to reflect the time value of money in the liability for remaining coverage but would be required to do so under the GMA.
Where there is significant financing component.	In this situation, an entity is required under the PAA to reflect the time value of money in the liability for remaining coverage using a discount rate locked in at initial recognition. The GMA with the current discount rate may produce a significantly different amount for the liability for remaining coverage from the PAA.
There is a significant non-separable investment service or other non-separable non-insurance component to the contract, or there is a significant profit-sharing component.	These are complications which the PAA was not designed to handle and where the PAA might not be a reasonable approximation of the GMA.
The cost of any derivatives embedded in the contract is significant.	Paragraph 54(a) refers to embedded derivatives in the cash flows as an example of where variability in the fulfilment cash flows could be significant. These are complications that the PAA was not designed to handle and where the PAA might not be a reasonable approximation of the GMA.
Coverage is deferred.	While the PAA might require the liability for remaining coverage to accrete interest, the longer the deferral period, the greater the mismatch is likely to occur between the underlying building blocks of the GMA and the PAA's liability for remaining coverage. The GMA will continue to update expectations of future cash flows, while the PAA will only adjust for changes in the timing for incurred claims in the coverage period if facts and circumstances change (see paragraph B127).
Longer duration contracts generally.	For many reasons already highlighted, the longer the contract, the greater the variability

	might be in the projected fulfiment cash flows under the GMA.
Contracts with level expected incurred claims and non-level policy administration and maintenance expenses.	The PAA would allocate the premium evenly over the contract period, while the GMA would recognise the non-level nature of the policy administration and maintenance expenses in the fulfilment cash flows.

7.6. For contracts whose coverage period is greater than 12 months in length, is it necessary to test whether the PAA is an approximation of the GMA?

IFRS17 does not explicitly require a test to demonstrate that the PAA is an approximation of the GMA. However, relevant stakeholders (such as an entity's auditors) might expect the entity to justify its use for groups which contain contracts with more than 12 months coverage. The justification required depends on the circumstances, although paragraph 54 suggests that the criterion is evaluated only at inception looking at "*significant variability in the fulfilment cash flows that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred.*"

For single premium contracts that run for only a few months more than a year, it may be sufficient to demonstrate that there is no obvious reason why the PAA would not be a reasonable approximation to the GMA over the coverage period.

In some simple circumstances, it may be possible to demonstrate mathematical equivalence between the PAA and the GMA. For example, this may be the case for single premium contracts if the expected incurred cost is level over the coverage period, the risk adjustment for non-financial risk is a flat percentage of the future cash flows, and the PAA reflects the time value of money.

For a longer-term group of single premium contracts, it may be desirable to perform a few sample calculations on both bases (i.e., PAA and GMA) in order to confirm similar results for the liability for remaining coverage.

Where there are future premiums or any other features that may indicate that the use of the PAA could be questionable (see question 7.5), it may be desirable to undertake more exhaustive testing. If such testing is unduly laborious, it may be an indication that the PAA is not appropriate for use.

If limited testing does not clearly indicate that the PAA is a reasonable approximation and PAA presentation is strongly preferred for such reasons as consistency with the rest of an entity's business, it may be necessary to undertake parallel calculations to confirm a reasonable approximation.

7.7. When is a group recognised?

The recognition criteria for groups under the PAA are the same as for the GMA. Paragraph 25 states:

An entity shall recognize a group of insurance contracts it issues from the earliest of the following:

a. the beginning of the coverage period of the group of contracts;

b. the date on which the first payment from a policyholder in the group becomes due; and

c. for a group of onerous contracts, when the group becomes onerous."

The first criterion is consistent with how entities in some jurisdictions that write short duration contracts currently recognise contracts under local GAAPs and IFRS 4.

7.8. What is the contract boundary?

The contract boundary is defined by paragraph 34 and discussed in Chapter 1 – Classification of Contracts.

The significance of the contract boundary in the context of the PAA lies in whether the contract has a coverage period of one year or less and is therefore automatically eligible for the PAA. For many non-life insurance contracts, neither the insurer nor the insured is obliged to renew, so the contract boundary is clear. Note that the coverage period can differ from the contract boundary at the inception. It is the coverage period that is considered in 53(b). See question 6.19.

The situation is rather less clear for compulsory insurances, where the right of the insurer to set a premium that fully reflects the risk is compromised in certain jurisdictions.

In cases of doubt, the actuary may seek guidance from the entity's technical accounting group to reach a consensus on the issue.

7.9. What is the initial measurement approach to the liability for remaining coverage?

The initial measurement under the PAA is set out in paragraph 55(a), which states:

(a) on initial recognition, the carrying amount of the liability is:

i. the premiums, if any, received at initial recognition;

ii. minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense applying paragraph 59(a); and

iii. plus or minus any amount arising from the derecognition at that date of the asset or liability recognised for insurance acquisition cash flows applying paragraph 27.

Under paragraph 59(a), if the coverage period is 12 months or less for each contract in the group at initial recognition the entity "may choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs." This may cause a material difference between the PAA and the GMA for the liability for remaining coverage, which is why it is only permitted when the coverage period is less than 12 months for each contract in the group and the safe harbour election of the PAA can be made.

An important change with IFRS 17 is that insurance revenue is based on premiums received rather than premiums written. Caution is needed to avoid double counting or omission in accounting balances (e.g., premiums due but not received).

For non-life insurance business on a single premium basis with the initial recognition when the premium is due, if the option in paragraph 59(a) is not taken, the overall effect is that of an unearned premium net of acquisition expenses. Instead of an initial unearned premium (UEP) equal to the written premium less an initial deferred acquisition cost equal to the deferrable acquisition costs ("DAC"), the initial UEP is effectively net of acquisition costs, and there is no DAC asset.

If the option discussed in paragraph 59(a) is taken, the initial liability for remaining coverage is equal to the premium received with no DAC. The effect of this is that the liability is greater than under IFRS 4 approaches, where acquisition costs are deferred.

The PAA does not capture any expectation of policy cancellations. If cancellations are significant, the liability for remaining coverage could be overstated, or for contracts with a coverage period of greater than 12 months, the PAA may not be an appropriate approach.

7.10. What is the subsequent measurement approach to the liability for remaining coverage?

The subsequent measurement under the PAA is set out in paragraph 55(b), which states:

(b) at the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:

(i) plus the premiums received in the period;

(ii) minus insurance acquisition cash flows; unless the entity chooses to recognise the payments as an expense applying paragraph 59(a);

(iii) plus any amounts relating to the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period; unless the entity chooses to recognise insurance acquisition cash flows as an expense applying paragraph 59(a);

(iv) plus any adjustment to a financing component, applying paragraph 56;

(v) minus the amount recognised as insurance revenue for coverage provided in that period (see paragraph B126); and

(vi) minus any investment component paid or transferred to the liability for incurred claims.

As set out in paragraph B126, insurance contract revenue is recognised in each accounting period;

a) on the basis of the passage of time; but

b) if the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.

In practice, it is possible to turn this procedure around and do a prospective, rather than a retrospective, calculation. If the group is not onerous, the PAA liability for remaining coverage is the (present) value of future revenue (less future premiums). For single premium contracts where future revenue is pro-rata (see question 7.12) and discounting can be ignored, acquisition costs are expensed, and there are no investment components, it may be easier to think in terms of unearned premiums and calculate premium revenue as unearned premiums at the start of the period, plus premiums received, minus unearned premiums at the end of the period, similar to current accounting practice.

Onerous contract liabilities and the circumstances under which the adjustment for the time value of money is required are discussed in questions 7.14 and 7.15.

7.11. What acquisition expenses are used in the initial measurement?

"Insurance acquisition cash flows" is a term defined in Appendix A of IFRS 17 and is used in Paragraph 59(a). They include commissions, underwriting costs, and contract set up expenses. For each group, all of these expenses must be directly attributable to the portfolio to which the group belongs. See Chapter 2 – Estimates of future cash flows.

If the option under paragraph 59(a) is elected, insurance acquisition cash flows would not be included in the initial measurement of the liability for remaining coverage.

7.12. How is revenue recognised for subsequent measurement periods?

As per question 7.10, revenue recognition under the PAA is specified in paragraph B126.

In practice, unless there are particular reasons to expect an uneven pattern, a good starting point might be a pro-rata assumption, modified to the extent demanded by credible experience. There is an inherent tension between using the broadest possible portfolio to maximise credibility and defining portfolios more narrowly to better reflect experience variations. The best balance is a matter of judgement.

There is also the question of what does "differs significantly from the passage of time" mean? This expression is not defined by IFRS 17, although the term "significant" is often used in accounting frameworks to relate that something has more than a remote likelihood of causing a misstatement. "Significant" appears to be a lower threshold than something that is "material", which is an accounting concept that refers to the impact that omitting, misstating, or obscuring information could reasonably be expected to have on the users of the financial statement.

For example, the storm damage component of the premium for a home-owners policy in Queensland, Australia, where cyclone season typically falls between November and April, would differ significantly from the passage of time. But other perils insured under the policy may have no such pattern or even offsetting patterns.

7.13. How should the liability for incurred claims be measured for contracts measured under the PAA?

The PAA generally uses the measurement approach for the liability for remaining coverage under the GMA.

However, there are minor simplifications that apply when measuring and presenting the liability for incurred claims if the group of contracts is initially measured under the PAA.

First, the entity is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred (see paragraph 59(b)).

Secondly, the GMA allows for an entity to elect to lock-in interest rates for purposes of recognising finance income or expenses over the life of a contract, with changes in market rates going through Other Comprehensive Income ("OCI"). Based on paragraphs B72(e)(iii) and B133, an entity that has used the PAA for measuring the liability for remaining coverage and wishes to lock-in discount rates shall do so based on the incurred date of the claim liabilities and not the initial contract recognition date as under the GMA. For practical purposes of implementation, one way to do this is to lock in a discount rate for each group based on the average insured event date of a period (quarterly or annual). This could be justified if the average claim size is assumed to be uniformly distributed over the period.

7.14. When and how should an onerous contract liability be recognised?

Onerous contracts, in the context of the PAA, are the subject of paragraphs 18 and 57, which state:

> 18 *For contracts issued to which an entity applies the premium allocation approach (see paragraphs 53–59), the entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. An entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.*
>
> 57 *If at any time during the coverage period, facts and circumstances indicate that a group of insurance contracts is onerous, an entity shall calculate the difference between:*
>
> *(a) the carrying amount of the liability for remaining coverage determined applying paragraph 55; and*
>
> *(b) the fulfilment cash flows that relate to remaining coverage of the group, applying paragraphs 33–37 and B36–B92. However, if, in applying paragraph 59(b), the entity does not adjust the liability for incurred claims for the time value of money and the effect of financial risk, it shall not include in the fulfilment cash flows any such adjustment.*

Referring to paragraph 18, unless there are facts and circumstances indicating that the portfolio is onerous, it is not necessary to assess whether any contracts are or may become onerous. The latter half of paragraph 18 indicates that the entity still needs to consider at inception whether to allocate the contracts in the portfolio to a group that has

no significant possibility of becoming onerous in subsequent periods or not, as described in paragraphs 16(b) and 16(c) based on the likelihood of the facts and circumstances changing during the coverage period.

Note that if the paragraph 59(a) option (to expense acquisition cash flows) is taken, the group would be less likely to be onerous or become onerous.

Contracts may be onerous at issue or may become onerous later during the coverage period. The wording "facts and circumstances" in this paragraph implies that an explicit test is not required. An explicit test is only needed when there is reason to believe that the group may be onerous. This is clearly a matter of judgement. Possible indicators that may inform the decision to conduct onerous contract testing include:

a. a group of contracts in the portfolio that is known to be onerous at initial recognition;

b. past losses in the portfolio;

c. aggressive underwriting or pricing;

d. unfavourable experience trends; and

e. unfavourable external conditions.

Groups of onerous contracts might also be identified by parallel fulfillment cash flows and PAA calculations. If a group is onerous, the excess of the fulfillment cash flows over the PAA liability for remaining coverage is recognised as a loss in the profit or loss (with a corresponding component established by increasing the liability for remaining coverage). See Chapters 2 through 6 for a discussion of fulfillment cash flows. The calculations are modified in accordance with paragraph 57(b) to exclude discounting, if the corresponding liability for incurred claims is, or would be, undiscounted in accordance with paragraph 59(b).

If at any time during the coverage period, facts and circumstances indicate that a group is onerous, it is necessary to recalculate the difference between the fulfillment cash flows valuation of the liability for remaining coverage and the PAA carrying amount (paragraph 57).

No loss component can arise for incurred claims, as these are not part of the liability for remaining coverage and are valued at current fulfilment value.

Onerous contracts are discussed further in Chapter 6 – Contractual Service Margin and Loss Component.

7.15. When is an adjustment made to the liability for remaining coverage for the time value of money required, and how is the adjustment made?

Adjustment for the time value of money is subject to paragraph 56, which states:

> *If insurance contracts in the group have a significant financing component, an entity shall adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk using the discount rates specified in*

paragraph 36, as determined on initial recognition. The entity is not required to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk if, at initial recognition, the entity expects that the time between providing each part of the coverage and the related premium due date is no more than a year.

An adjustment is required where there is a "significant financing component" to contracts in a group. Discussion of "significant financing component" is found in paragraphs 60-61 of IFRS 15 Revenue from Contracts with Customers.

It is optional to adjust the liability for remaining coverage for the time value of money if the time between providing the relevant portion of insurance coverage and the due date for the corresponding premium is expected to be 12 months or less.

Normally, a significant financing component would occur if premiums are paid significantly in advance of coverage being provided. In this case, interest would be accreted on the liability for remaining coverage, and this would also increase the amount of insurance revenue recognized.

The discount rates to be used are the locked-in rates determined at initial recognition of the group of contracts. See Chapter 3 – Discount rates.

7.16. If the entity elects to use OCI for changes in interest rates in subsequent measurement periods for the liability for incurred claims, what is the locked-in discount?

If electing the OCI option to minimise the volatility from changes in interest rates in profit or loss, the discount rate under the GMA is locked in at the date of recognition of the group. The IASB has allowed for a practical difference with the PAA in paragraph B72(e)(iii), whereby the discount rate for incurred claims is locked in based on the date claims are incurred. Effectively, for practical purposes, for many groups this would imply the locked-in discount rate would be based on the average incurred date of a period (e.g., quarterly or annual).

7.17. How is ceded reinsurance dealt with under the PAA?

Under paragraph 69, the PAA may be used for groups of reinsurance contracts held if they meet the same criteria as for direct insurance contracts. For proportional reinsurance, this may be the case if the group of underlying contracts is eligible for the PAA assuming the coverage is on a losses-occurring basis, where the reinsurer covers losses that occur for a contractually defined period of time. This is not necessarily true for proportional reinsurance on a policies or risks-attaching basis, where the reinsurer covers losses arising from policies written over a defined period of time. For example, if a reinsurance contract attaches policies over a one-year period and the attaching policies are also written over a one-year period, then the reinsurance contract would have a coverage period of two years and would not be automatically eligible for PAA based on coverage of one year or less.

Conversely, non-proportional reinsurance is typically written on a losses-occurring basis and may be eligible for the PAA even if the underlying direct contracts are not as long as

the coverage period is one year or less. Some non-proportional reinsurance is unlikely to qualify for the PAA. For example, aggregate covers with a term in excess of one year may not qualify if the pattern of risk amortisation differs significantly from the pattern of expected incurred claim costs. See question 7.5.

7.18. How is assumed reinsurance dealt with under the PAA?

Paragraph 3 indicates that IFRS 17 applies to "insurance contracts, including reinsurance contracts" an entity issues. IFRS 17 does not explicitly differentiate between the treatment of an issued insurance contract and an issued reinsurance contract. Consequently, the PAA may be used if the reinsurance contract meets the requirements of paragraph 53. It is worth noting again that a risks-attaching reinsurance contract, even with a contract length of one year, would not automatically be eligible for the PAA under paragraph 53(b), as the coverage provided would be in excess of one year, but it might still be possible to apply PAA.

Under a non-proportional reinsurance treaty, particularly some catastrophe covers (such as those covering aggregate losses), the pattern of risk amortisation may differ significantly from the pattern of expected incurred claim costs and therefore may not qualify for the PAA if the contracts have coverage periods in excess of one year.

7.19. When and how does an entity bifurcate non-insurance features under the PAA?

Non-insurance features are treated in the same way under the GMA and the PAA. Separation is discussed in questions 1.7 and 1.8. After separation, the insurance part of the contract is valued in the same way as a stand-alone contract.

7.20. How are results presented under the PAA?

See Section E – Presentation and Disclosure.

7.21. How is transition to IFRS 17 treated if the entity will measure its liabilities using the PAA?

See Chapter 12 – Transition. The PAA is not explicitly mentioned in Appendix C, which covers transition.

It will usually be straightforward to apply the PAA retrospectively in accordance with paragraph C4, because there is no separate identification of the risk adjustment for non-financial risk or the CSM. However, there may be some limitations related to internal data capture and systems especially for groups that have been in force longer than one year.

7.22. How are contract modifications handled under the PAA?

Contract modifications are the subject of paragraphs 72 and 73.

Paragraph 72 indicates that for some types of contract modification, "*an entity shall derecognise the original contract and recognise the modified contract as a new contract*." Paragraph 72 further notes that the "*exercise of a right included in the terms of a contract is not a modification*" and provides an exhaustive list of conditions under which the contract can be derecognised if, and only if, one or more of the conditions is met. These

conditions include a modification that would have changed the group to which the contract would have been assigned at inception or a modification that would have changed a group from being accounted for under the PAA to no longer being eligible for that simplification.

Paragraph 73 is written in terms of the GMA, indicating that if none of the conditions are met under paragraph 72 the "*entity shall treat changes in cash flows caused by contract modifications as changes in estimates of fulfilment cash flows by applying paragraphs 40-52.*" Paragraphs 40-52 detail subsequent measurement under the GMA. For contracts where the PAA is applied, guidance for subsequent measurement is in paragraph 55(b).

See also Chapter 14 – Contract Modifications and Derecognition

Chapter 8 – Contracts with Participation Features and Other Variable Cash Flows

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

8.A. What does this chapter address?

This chapter considers the recognition, measurement, and presentation of contracts with participation features ("participating contracts") for insurance contracts with direct participation features as well as for other types of participating contracts with cash flows subject to the discretion of the insurer or linked to indices. This chapter also addresses the criteria to be met for using the approach to be adopted for such contracts, which is known as the variable fee approach ("VFA"). The specific considerations on transition for participating contracts are covered in chapter 12 – Transition.

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

Paragraphs 45, 48(b), 71, 72, 87, 89, 111-113, B27, B67-B71, and B101-B118 provide guidance on this topic. In particular, paragraphs B101-B118 provide key details on this subject.

Paragraphs BC165-BC170, BC171-BC174, BC237-BC257, BC264-BC269, BC276, BC365, and BC366 also provide background on the subject.

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

None

General Issues

8.1. What are the types of participating contracts?

IFRS 17 defines different types of participation:

a) Insurance contracts with direct participation features, ("Direct Participating Contracts" or "DPCs"), which are defined in Appendix A and paragraph B101 and accounted for using a variation of the approach used for insurance contracts without direct participation features (i.e., sometimes called the Variable Fee Approach or VFA).

b) Investment contracts with discretionary participating features, which are defined in Appendix A and accounted for under IFRS 17 (with minor modifications) rather than IFRS 9 using a variation of the approach used for insurance contracts.

There are many different types of participating contracts in each jurisdiction that do not meet the definition of a) or b) above. Each type of insurance contract will need to be examined to determine if it meets the requirements to be a DPC (see question 8.3) or an Investment Contract with Discretionary Participation Features (DPF). For example, some contracts may have discretionary payments that depend on the return on assets but do not meet one of the other requirements to be defined as a DPC. Participating contracts

that do not meet all the requirements to be a DPC are measured as insurance contracts without direct participation features.

In assessing whether a contract is a DPC, careful consideration must be made of the impact of guarantees both in terms of guaranteed returns and guaranteed benefit amounts, as this will impact whether the requirement of paragraphs B101(b) and B101(c) are met (see paragraph B108). This means there may be insurance contracts within the same product type that fail to meet the definition for a DPC, while others meet the definition (e.g., where products with different levels of guarantees are available). It is possible that some contracts within a product type could be measured as DPCs, while others are measured as insurance contracts without direct participation features. The classification is made at initial recognition of a contract by the entity and never revised except in the case of a subsequent contract modification (see question 8.10). Each entity will have to make its own determination.

8.2. Can a reinsurance contract be a DPC?

No. A reinsurance contract, issued or held, is deemed to never meet the requirements to be a DPC and therefore is measured in the same way as an insurance contract without direct participation features (see paragraphs B109, BC248, and BC249). See also Chapter 9 – Reinsurance.

Contracts with Direct Participation Features

8.3. What is the definition of a Contract with Direct Participation Features?

In Appendix A, a DPC is defined as:

*An **insurance contract** for which, at inception:*

*(c) the contractual terms specify that the **policyholder** participates in a share of a clearly identified pool of **underlying items**;*

*(b) the entity expects to pay to the **policyholder** an amount equal to a **substantial share** of the fair value returns on the **underlying items**; and*

*(c) the entity expects a **substantial proportion** of any change in the amounts to be paid to the **policyholder** to vary with the change in fair value of the **underlying items**.*

For a DPC, the coverage period implicitly includes the period when the contract provides investment services as well as insurance services.

IFRS 17 uses “fair value” in several places (such as the above definition of a DPC). If there is a need to determine the fair value, the determination follows the guidance of IFRS 13, as IFRS 17 does not provide guidance for determining the fair value (see chapter 10 – Fair Value).

8.4. What does an "*underlying item*" mean?

The requirement is that underlying items are clearly identified by the contract. The definition of underlying items is given in Appendix A and expanded upon in paragraph B106:

> *Items that determine some of the amounts payable to a policyholder. Underlying items can comprise any items; for example, a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity.*

The definition is not specific to DPCs only. Other contracts can also refer to underlying items. Some of the amounts payable to policyholders will vary according to variations in the value of the underlying items.

Paragraph B106 provides information about the composition of underlying items. This could be all or some of the net assets of the entity or a reference portfolio that does not necessarily need to include assets held by the entity.

Though Appendix A and paragraph B106 limit examples of underlying items to assets, both indicate that the pool of underlying items can comprise other items. It can be generally assumed that any item of determinable and variable value can be an underlying item (e.g., the underlying items could be a defined external index).

To refer to all underlying items that affect amounts payable to policyholder, IFRS 17 refers to the pool of underlying items.

8.5. What does "*clearly identified pool of underlying items*" mean?

As paragraph B101(a) refers to policyholders having a contractual share in the pool of underlying items, the pool of underlying items needs to be clearly identified and measurable to be effective.

Further guidance about the meaning of "clearly identified" can be found in paragraph B101(a), B105 and B106. Items in the pool of underlying items cannot be exchanged with retrospective effect. It is similarly not possible to withdraw fair value changes from the pool of underlying items once they have occurred by exchanging the respective items (e.g., at historical cost).

Considering the purpose of the condition, some believe that the requirement of "clearly identified" underlying items might not require a 100% ring-fenced fund. Very often, the returns on underlying items include the effect of cost allocations which are not necessarily fully contractually identified. According to those views, this is seen as tolerable if the volume of such unidentified amounts cannot affect the share of policyholders significantly. Ultimately, whether a contract is deemed to meet the criteria of a DPC is up to the entity and its auditors.

8.6. What does a "contractual specification pf participating in a share of a pool of underlying items" mean?

In order to meet the definition of a DPC, paragraph B105 requires that the link to underlying items be "enforceable", without precluding the existence of the entity's discretion to vary the amounts paid to policyholders. Enforceability (paragraph 2) is a matter of law. This can be contractual (contracts need not be written and can be implied by "an entity's customary business practices") and includes terms imposed by external parties, such as law or regulation. Enforceability cannot be assumed to apply for all rights and obligations within a contract. In some cases, the policyholder or another entity (e.g., a regulatory authority in lieu of the policyholder) is able to force the insurer to provide the policyholder a specific share of the pool of underlying items, while the specific share which is enforceable may depend on the specific value of the pool of underlying items or its movements.

8.7. Can profits from portfolios of certain insurance contracts owned by participating contracts qualify as underlying items?

This will depend on the nature of those profits and the features of the insurance contracts. The definition of an underlying item and of the criterion in paragraph B101(a) does not exclude this possibility.

8.8. What are some examples of situations that do not meet the requirements for a clearly identified pool of underlying items?

The following examples are set out in paragraph B106 as not meeting the requirements for a clearly identified pool of underlying items:

a) an entity can change the underlying items that determine the amount of the entity's obligation with retrospective effect; or

b) there are no underlying items identified, even if the policyholder could be provided with a return that generally reflects the entity's overall performance and expectations, or the performance and expectations of a subset of assets the entity holds. An example of such a return is a crediting rate or dividend payment set at the end of the period to which it relates. In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set, and does not reflect identified underlying items.

This latter example would exclude some universal life and participating contracts from qualifying as DPCs if the credited rate or dividend payments are based on something other than a share of a clearly identified pool of underlying items. Note these are just examples, and there may be other items that do not meet the requirements for a clearly identified pool of underlying items.

8.9. What does "*a substantial share or substantial portion*" mean?

IFRS 17 does not specifically define what "*substantial*" means. In paragraph B101(b), the requirement is that the policyholder shares in a "*substantial share of the fair value returns on the underlying items*", and in paragraph B101(c), a "*substantial proportion*" of the

amounts paid to policyholders is expected to vary with the fair value of the underlying items.

The outcome of this requirement is that negative as well as positive impact of the fair value returns are shared.

Also, the criterion set out in paragraph B101(c) would not be met for contracts where the degree of policyholder participation is limited (e.g., contracts where minimum guarantees mean that the returns to policyholders are based on expectations at outset, largely fixed in nature, and do not vary with the underlying items).

The criteria in paragraphs B101(b) and B101(c) are further clarified in paragraph B107. The assessment is not made on a period-by-period basis but rather over the duration of the insurance contract and "*on a present value probability-weighted average basis, not a best or worst outcome basis*" (see paragraph B107(b)(ii)).

8.10. When does the assessment of whether a contract meets DPC requirements take place?

The assessment takes place at initial recognition and is not repeated at any subsequent reporting period. Therefore, insurance contracts that originally had sufficient pass-through expectation, but where minimum guarantees subsequently become much closer to being in the money, remain DPC if they qualified as such at initial recognition.

However, if the contract is subject to a contract modification which, if made at or before that assessment, would have changed the assessment made, then the original contract is de-recognised, and a new (modified and reassessed) contract is recognised. (See Chapter 14 – Contract Modifications and Derecognition.)

Also, at transition to IFRS 17, if the fair value or modified retrospective approach is used, there may be circumstances where the assessment takes place at transition. See questions 12.34 and 12.41

For other special considerations, see Chapter 11 – Business Combinations and Portfolio Transfers and Chapter 12 – Transition.

8.11. What is the conceptual basis for measuring DPCs?

Normally, an entity benefits directly from all of the success (i.e., the surplus) in fulfilling a contract applying its own resources. The entity owns the resulting net assets. In the case of DPCs, a portion of that surplus belongs to policyholders. The contract defines the mechanism for determining the entity's share of that surplus.

For these contracts, the entity's share has the character of a contractual fee to be charged by the insurer to the surplus, which may be similarly variable as the surplus is (i.e., a variable fee). With that understanding, the surplus is owned by the policyholders except for the accumulation of a contractually defined fee.

Accordingly, the return on the pool of underlying items is not to be presented in that period as income but as remuneration for the entire services provided under the contract. Any such remuneration is to be allocated to periods as insurance revenue when the services are provided. Therefore, any change in the expectation of that contractual fee

adjusts the Contractual Service Margin ("CSM"), rather than the profit and loss account accordingly. This additional adjustment of the CSM is the key difference between the measurement of DPCs and other contracts under IFRS 17. Profits of DPCs are recognised in line with the provision of service rather than presented as surplus earned, be it on a statutory or fair value measurement basis.

The IASB expanded that concept to cases where policyholders participate only in parts of the surplus (e.g., only in investment returns exceeding minimum interest guarantees) or even cases where the pool of underlying items is an external index (e.g., a stock index) not directly affecting the insurer financially. In such cases, where the policyholder's benefits are not based directly on assets held by the insurer, earnings may prove to be volatile, the extent of which will depend on the terms of the policy.

The detail of this subsequent measurement is set out in paragraphs B110-B114 with further comments in paragraphs BC238-BC247.

Unlike insurance contracts without direct participation features for the CSM, "*all the adjustments are measured using current discount rates*. (see paragraph B113(a)).

The different adjustments to the CSM do not have to be identified separately (see paragraph B114).

Note that insurance contracts that meet the definition of a DPC would normally not be eligible to use the Premium Allocation Approach ("PAA"), which is described in Chapter 7 – Premium Allocation Approach.

8.12. How do DPCs work on initial recognition?

On initial recognition, the approach for DPCs is identical to the approach used for insurance contracts without direct participation features. Fulfilment cash flows and a CSM are determined in the same manner as set out in paragraphs 32-39. (See Chapter 2 – Estimates of Future Cash Flows and Chapter 6 – Contractual Service Margin and Loss Component.)

8.13. What discount rate is used for measurement?

There is no specific guidance for discounting of DPCs. The guidance applicable for any cash flows that vary based on the returns on underlying items applies, which is discussed in Chapter 3 – Discount Rates. This applies to both initial measurement and subsequent measurement.

8.14. How are DPCs measured subsequently?

Fulfilment cash flows for DPCs are determined in the same manner as for contracts without direct participation features. The special measurement requirements for DPC only affect the CSM, as follows:

a. The CSM is adjusted for the change in the entity's share of the fair value of the underlying items (see paragraphs 45(b) and B112) except to the extent that risk mitigation is applied (see paragraph B115 and question 8.16). This additional

adjustment to the CSM does not have to be identified separately from the generally applicable adjustments (paragraph B114).

b. There is no explicit accretion of interest on the CSM, as this is implicit in (a).

c. The adjustment for changes in fulfilment cash flows that do not vary based on the returns on underlying items is measured using current discount rates (see paragraph B113(a)) rather than locked-in discount rates.

d. The adjustment for changes in fulfilment cash flows that do not vary based on the returns on underlying items includes the change in the effect of the time value of money and financial risks not arising from the underlying items (see paragraph B113(b)) except to the extent that risk mitigation is applied (see paragraph B115 and question 8.15).

e. The cost of providing investment-related services is included in the determination of coverage units when releasing the CSM.

More information on subsequent measurement is set out in paragraphs B110 to B114 with further comments in paragraphs BC238 to BC249.

8.15. What is the additional adjustment of the CSM for DPCs?

The CSM of contracts without direct participation features is not adjusted for changes in the estimate of fulfilment cash flows due to financial risk rather it is based on the locked in rate from inception. For contracts with direct participation features, changes of the fulfilment cash flows due to financial risk, even if not related to future service, also adjust the CSM but measured applying the current interest curve rather than the locked-in one (see paragraph B113 (a)).

Changes in the fulfilment cash flows that do not vary based on the returns on underlying items consist of two categories. Paragraph B113b) states:

> *the change in the effect of the time value of money and financial risks not arising from the underlying items; for example, the effect of financial guarantees. These relate to future service and, applying paragraph 45(c), adjust the contractual service margin...*

In paragraph B113(a), all other changes in estimates of the fulfilment cash flows that do not vary based on the returns on underlying items apart from those in B113(b) are treated in the same manner as insurance contracts without direct participation features and hence

> *An entity shall apply paragraphs B96–B97, consistent with insurance contracts without direct participation features, to determine to what extent they relate to future service and, applying paragraph 45(c), adjust the contractual service margin.*

8.16. How does risk mitigation such as hedging impact the measurement of DPCs?

If risk mitigation is used, then for DPCs the entity can choose to put some or all of the changes in the entity's share of the underlying items due to the effect of the time value of

money and financial risk, or the paragraph B113(b) component of the variable fee, through profit or loss instead of the CSM. The entity's share of the underlying items can be mitigated by either derivatives or reinsurance contracts held. The effect on the variable fee can also be mitigated using non-derivative financial instruments measured at fair value through profit or loss as well as by derivatives and reinsurance held. This is to remove accounting mismatches (paragraph B115).

This would allow the change in the fair value of the mitigating items (which goes through profit or loss) to be offset by an equivalent portion of the change in fulfilment liabilities that would otherwise adjust the CSM.

Requirements related to the application of paragraph B115 are set out in paragraph B116:

"*… an entity must have a previously documented risk-management objective and strategy for mitigating financial risk as described in paragraph B115.I In applying that objective and strategy:*

a) an economic offset exists between the insurance contracts and the derivative, non-derivative financial instrument measured at fair value through profit or loss, or reinsurance contract held (i.e., the values of the insurance contracts and those risk mitigating items generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated). An entity shall not consider accounting measurement differences in assessing the economic offset.

b) credit risk does not dominate the economic offset."

Also, paragraph B117 requires paragraph B115 to be applied consistently in each reporting period.

Finally, if the conditions required to use this approach are no longer met, then the approach cannot be used from that date, however, previous periods are not adjusted retrospectively (see paragraph B118).

The risk mitigation option has no effect if the hedging items are themselves part of the pool of underlying items (e.g., if policyholders share in the entire surplus of the entity and the derivatives are held by the entity).

8.17. What happens when a DPC is modified?

If the terms of a contract are changed so that the insurance contract no longer meets the requirements for DPC (paragraph 72), the original contract is derecognised and a new contract recognised based on the modified terms. See chapter 14 – Contract Modifications and Derecognition.

8.18. Are there any special requirements for a DPC on transition?

There are specific requirements for DPC on transition. Some of the requirements differ from insurance contracts without direct participation features. See Chapter 12 – Transition.

Investment Contracts with Discretionary Participating Features

8.19. What is the definition of an "*investment contract with a discretionary participating feature*"?

Appendix A provides the following definition:

A financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:

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

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

c. that are contractually based on:

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

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

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

The treatment of these contracts is covered in paragraph 71, and paragraph B27(a) confirms that these contracts, although not insurance contracts, are in the scope of IFRS 17 "*provided they are issued by an entity that also issues insurance contracts*".

8.20. *What is an example of investment contracts' discretionary cash flows?*

One common example would be discretionary interest payments on a savings-type product if all conditions as outlined in question 8.19 are met.

8.20 How are investment contracts with discretionary participation features measured?

Investment contracts with discretionary participation features are subject to the same measurement considerations as insurance contracts with three modifications as described in paragraph 71:

- The date of initial recognition is the date the entity becomes party to the contract;
- The contract boundary is defined in terms of the entity's obligation to deliver cash; and
- The coverage units for release of the CSM reflect investment services.

Investment contracts with DPF often share many characteristics with insurance contracts with participation features and may share common underlying items. Investment contracts with DPF may also qualify as DPCs if they meet the conditions in paragraph B101.

Other Types of Participating Contracts (Non-VFA)

8.21. What are some other types of participating contracts?

Universal life or participating insurance contracts where credited rates or dividends (e.g., bonuses) are established on a basis that is not linked to a clearly identified pool of underlying items are the most common type of participating contract that may be classified as Non VFA. For example, contracts where there is no enforceable sharing mechanism specified, so the dividend (bonus) can be adjusted to support performance on other contracts might not meet the requirements for a DPC. There are, however, a great variety of such contracts worldwide, and thus actuaries may need to provide support to the entity's assessment of the particular contract to determine whether it meets the requirements to be a DPC.

8.22. How are discretionary cash flows and liabilities on those contracts measured?

Such contracts are measured using the general measurement approach ("GMA") discussed in Chapters 2 through 6.

Future payments to the policyholder under the contract that are at the discretion of the insurer are included in the measurement of the contract if they are directly related to fulfilment of the contract and if they are within the contract boundary (paragraph B65). Normally in accounting, discretionary payments would be recognised only when the entity accepts an obligation for payment. Under IFRS 17, however, they are measured on an expected value basis anticipating the expected behaviour of the insurer regarding those future decisions. Special care might be needed if the inclusion of discretionary payments makes contracts onerous or more onerous, particularly if the insurer might have the ability to reduce the payment to eliminate the loss.

Any change in the discretionary element paid to policyholders relates to future service and adjusts the CSM. In order to assess if such a change has arisen, an expected basis for these discretionary payments is included in the fulfilment cash flows at inception (paragraph B98). The CSM is then adjusted for deviations from these expected cash flows subject to the following.

- Changes in these payments can arise as a result of changes in financial risk on that commitment, which do not adjust the CSM, and "*the effect of discretionary changes to that commitment*", which adjust the CSM (paragraph B99).
- If it is not possible to separately specify the commitment at inception and the discretionary element, then the commitment is regarded "*to be the return implicit in the estimate of the fulfilment cash flows at inception of the contract, updated to reflect current assumptions that relate to financial risk.*" (paragraph B100).

When cash flows in one group (either a DPC or not) are impacted by cash flows in another group

8.23. In what circumstances are cash flows in one group considered to be impacted by cash flows in another group?

IFRS 17 recognises that off-setting effects between insurance contracts may arise in some circumstances and has a section on "*Contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts*" (paragraphs B67-B70).

In such cases, the insurer usually reduces discretionary benefits to policyholders if losses from other contracts arise. Often, the ability to reduce (discretionary) benefits is a contractual right of the insurer, and it is at the entity's discretion which losses it may consider in determining the discretionary benefits. Therefore, the discretionary benefits are simply measured as expected to be paid taking into account any expected reduction for losses from other contracts.

Other types of "*mutualisation*" such as "*the effects of specific contractual terms to general risk diversification*" (paragraph BC171) are not included.

Since the measurement under IFRS 17 is based on groups, off-setting effects within groups are implicitly included in the measurement approach. Paragraphs B67-B70 discuss effects arising between groups. The important point for the fulfilment cash flows is not to double count any impacts. Payments that have been included in the cash flows of one group are not included in the cash flows of another.

These offsetting effects may not always eliminate the risk that contracts turn out to be onerous. That is the case if the insurer is not able to off-set the entire loss from contracts by reducing benefits otherwise payable to other contracts but needs to bear a part of the loss.

As in other areas, IFRS 17 does not prescribe the approach to allow for the benefit / impact of this off-setting. Different practical approaches are allowed. IFRS 17 does recognise that this practical approach may be at a higher level of aggregation than the individual groups. If this is the case, then a systematic and rational approach is used to allocate the effect of off-setting to individual groups. Groups are still subject to the annual grouping requirement just as for contracts with no such off-setting mechanism, though in some cases the effect of off-setting will reduce the impact of annual grouping (e.g., if sharing has the effect of equalising the profitability of groups issued in different years). For more discussion of the level of aggregation, see BC138 and BC139. While this is not part of the standard, BC 138 does acknowledge that it may not be necessary to methodologically restrict the groups to annual issues if the same result is obtained.

8.24. How is the obligation measured if surplus currently earned is expected to be paid to future policyholders?

In some systems, the entity has the discretion to pay participating benefits (i.e., distribute surplus) currently earned to future policyholders. The benefits can be paid even after the coverage period of some or all of the contracts generating that surplus is expired.

Paragraph B71 grants the simplification that once the contracts of the group generating the surplus have been derecognised and those future amounts can be measured collectively rather than separately for each group.

Mutual Entities

8.25. Is there any special accounting guidance for mutual entities?

The precise nature of mutual entities varies widely. In some mutual entities, policyholders or subsets of policyholders may, in addition to holding a contract, also share in the residual interest of the entity (i.e., "*the most residual interest of the entity is due to a policyholder and not a shareholder*" (paragraph BC265)). However, there is no general rule that entities referred to as "mutual entities" actually grant a policyholder such a right.

The accounting treatment will depend on the exact facts and circumstances of the mutual entity in question in identifying the rights and obligations of the entity under the contract as required in paragraph 2.

This means that some policyholders will have two identities. The first, a policyholder of the mutual insurer / entity, and the second, an owner of the mutual entity / insurer. These two roles are considered separately (paragraph B16).

The OCI Option

8.26. What is the other comprehensive income ("OCI") option?

Paragraph 87 states:

The insurance finance income or expenses comprises the change in the carrying amount of the group of insurance contracts arising from:

a. the effect of the time value of money and changes in the time value of money; and

b. the effect of financial risk and changes in financial risk; but

c. *excluding any such changes for groups of insurance contracts with direct participation features that would adjust the contractual service margin but do not do so when applying paragraphs 45(b)(ii), 45(b)(iii), 45(c)(ii) or 45(c)(iii). These are included in insurance service expenses.*

An entity can make an accounting policy choice between including the full amount of the insurance finance income or expense in profit or loss or disaggregating this amount between profit or loss and OCI using a systematic allocation of the expected total insurance finance income or expenses over the duration of the group for contracts without direct participation features (paragraph 88).

For contracts where financial risk has a substantial effect on the amounts paid to policyholders (i.e., most participating contracts), there is specific guidance for systematic disaggregation. The disaggregation eliminates accounting mismatches with income or expenses included in profit or loss on the underlying items held (paragraph 89).

In both cases, the balance of the amount included in profit or loss on disaggregation and the total amount of insurance finance income or expenses in the period is included in OCI (paragraph 90). The accounting policy choice as to whether to disaggregate insurance finance income or expenses is made at the portfolio of insurance contracts level and is made in conjunction with an assessment of the treatment of the portfolio of assets (paragraph B129):

8.27. How does the OCI option apply to DPCs holding the underlying items?

If an entity chooses to disaggregate insurance finance income or expenses for DPCs, where the entity holds the underlying items, in the profit or loss the insurance finance income or expenses on the liabilities is equal and opposite to the income or expenses included in profit or loss for the underlying items resulting in "the net of the two separately presented items being nil" (paragraph B134).

If the application of the OCI changes because the entity no longer owns the underlying items, the amount accumulated in OCI is included as a reclassification adjustment in profit or loss. This is based on the amount previously included and is not recalculated for the approach now applying, or the new assumptions. Paragraph B135 (a) states:

i. if the entity had previously applied paragraph 88(b)—the entity shall include in profit or loss the accumulated amount included in other comprehensive income before the change as if the entity were continuing the approach in paragraph 88(b) based on the assumptions that applied immediately before the change; and

ii. if the entity had previously applied paragraph 89(b)—the entity shall include in profit or loss the accumulated amount included in other comprehensive income before the change as if the entity were continuing the approach in paragraph 89(b) based on the assumptions that applied immediately before the change.

No restatement of prior periods is required (paragraph B135(b)).

8.28. How does the OCI option apply for other participating contracts?

For contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholder but which are not DPC, the disaggregation is based on a systematic allocation of the expected total finance income or expenses over the duration of the group (see paragraph B130). The systematic allocation is based on characteristics of the contracts without reference to factors that do not affect the cash flows expected to arise under the contracts. In other words, if expected recognised returns on assets do not affect the cash flows of the contracts in the group, the impact of those returns is excluded (see paragraph B130(a)).

The systematic allocations are also such that over the duration of the groups the total amount recognised in OCI is zero. This means that when a contact matures the carrying amount of the group is equal to the amount measured using the systematic allocation (paragraph B130(b)).

The systematic allocation of the future cash flows can be determined in one of two ways as stated in paragraph B132(a):

(i) using a rate that allocates the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate; or

(ii) for contracts that use a crediting rate to determine amounts due to the policyholders—using an allocation that is based on the amounts credited in the period and expected to be credited in future periods.

The effective yield approach is described in the illustrative examples (IE 159):

> *Applying paragraph B132(a)(i), the entity uses a rate that allocates the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate (an 'effective yield approach'). The effective yield approach is not the same as the effective interest method as defined in IFRS 9 Financial Instruments Appendix A.*

If the financial assumptions remain the same through the years (i.e., no changes related to future cash flows), the calculated effective yield will remain the same. However, if the financial assumptions change, a revised effective yield will need to be calculated (see Paragraph B132). The amount going through the insurance finance income/expense in profit or loss will be calculated using this effective yield rather than the initial discount rate. The difference between this and the total impact will go through OCI.

The second of these is the crediting rate approach and is described in the illustrative examples (IE 165):

> *Applying paragraph B132(a)(ii), the entity uses an allocation based on the amounts credited in the period and expected to be credited in future periods (a 'projected crediting rate approach'). In addition, applying paragraph B130(b), the entity needs to ensure that the allocation results in the amounts recognised in other comprehensive income over the duration of the group of contracts totalling to zero. In order to do so, the entity calculates a series of discount rates applicable to each reporting period which, when applied to the initial carrying amount of the liability equals the estimate of future cash flows. This series of discount rates is calculated by multiplying the expected crediting rates in each period by a constant factor (K).*

Using the crediting rate approach might include the following steps:

1. Calculate the fair value of liabilities on current assumptions (in this example they increase when interest rates fall).
2. Solve for rates which "amortise" the difference between the new value and the original estimate in proportion to how interest is credited.
3. This scaling factor then scales the future outstanding crediting rates up through time. This results in the movements on the liability side closely matching the movements on the asset side.
4. In all cases, the OCI balance must be re-spread when conditions change, so that the outstanding OCI balance at the end is zero.

For the risk adjustment for non-financial risk, if the risk adjustment is also disaggregated, the systematic allocation used is consistent with the allocation of the future cash flows.

For the CSM, the systematic allocation uses the discount rate used to accrete interest (locked-in rate) (paragraph B132). For DPC, whether the entity holds the underlying items or not, the adjustment to the CSM according to paragraph 45(b) is disaggregated in line with the disaggregation of the respective policyholders' share.

Presentation and Disclosures

8.29. Are there any differences with respect to presentation for DPCs?

There are no specific presentation requirements for DPCs. See Section E – Presentation and Disclosure.

8.30. Are there any additional disclosures required for DPCs?

For disclosures, an entity is required to explain the relationship between insurance finance income or expenses and the investment return on its assets (paragraph 110).

- The composition of the underlying items and their fair value is also disclosed (paragraph 111).
- If risk mitigation is used and the CSM is not adjusted for some changes in the fulfilment cashflows, the impact of this on the CSM is disclosed (paragraph 112).
- If the basis for disaggregation of insurance finance income or expenses is changed, then the period when the change occurred, the reason, any adjustments as a result, and the carrying amount of the contracts to which the change applied are disclosed (paragraph 113).

See also Section E –Presentation, and Disclosure.

Chapter 9 – Reinsurance

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

9.A. What does this chapter address?

This chapter provides background and suggested practice on the measurement of reinsurance arrangements that are considered reinsurance contracts in scope of IFRS 17. The note covers both reinsurance ceded (referred to as reinsurance "held" in IFRS 17) and reinsurance assumed (referred to as reinsurance "issued" in IFRS 17). As noted in paragraph 3, IFRS 17 is applicable to both reinsurance contracts held, and reinsurance contracts issued. For consistency with IFRS 17 terminology, reinsurance "held" and "issued" will be used in this note. Retrocession contracts are included in the definition of reinsurance contracts.

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

As noted in paragraph 4, all references in IFRS 17 that refer to insurance contracts also apply to reinsurance contracts held unless otherwise indicated by specific reference to reinsurance issued or as specified in paragraphs 60–70A for reinsurance held.

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

None

9.1. When is IFRS 17 used to account for reinsurance contracts?

A reinsurance contract is an insurance contract where one entity (the reinsurer) takes on all or part of the insurance risks associated with insurance contracts issued by another entity. When an entity transfers risks associated with underlying insurance contracts to another entity it is known as reinsurance held (the IFRS 17 terminology for reinsurance ceded). When an entity receives risks associated with insurance contracts issued by another entity it is known as reinsurance issued (the IFRS 17 terminology for reinsurance assumed). Where there is significant insurance risk transfer, the reinsurance contract is considered as an insurance contract under IFRS, and IFRS 17 is applicable (paragraph 3). This applies to both reinsurance held and reinsurance issued.

IFRS 17 outlines the criteria to determine whether there is significant insurance risk transfer under the contract (see question 9.2 below). Where a contract fails these criteria, IFRS 17 does not apply.

9.2. What constitutes significant insurance risk transfer for reinsurance?

To determine if IFRS 17 is applicable, for each reinsurance arrangement that an entity has in place, an assessment needs to be made as to whether there is significant insurance risk transfer. The criteria are covered in detail in paragraphs B7-B23. See Chapter 1 – classification of contracts.

Under IFRS 17, an insurance contract is one under which one party accepts significant insurance risk, other than financial risk, from another party by agreeing to compensate the other party if a specified uncertain future event (the insured event) adversely affects the other party.

Under IFRS 17, paragraph B18 states *the insurance risk is significant if, and only if, an insured event could cause the insurer to pay additional benefits that are significant in any single scenario, excluding scenarios that lack commercial substance (i.e., have no discernible effect on the economics of the transaction). IFRS 17 specifically says this condition may be met even if the insured event is extremely unlikely or even if the expected (i.e., probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows. Paragraph B19 goes on to state that a contract transfers significant risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis*.

For reinsurance, the following considerations apply:

- Lapse, persistency or expense risk would not normally meet the criteria for insurance risk outlined above, *because the resulting variability in the payment to the policyholder is not contingent on an uncertain future event that adversely affects the policyholder* (paragraph B14). However, *if the entity mitigates its risk by using a second contract to transfer part of the non-insurance risk to another party, the second contract exposes the other party to insurance risk* (paragraph B15). Therefore, the assumption of lapse, persistency and expense risk can (if significant) meet the definition of an insurance contract (reinsurance contract issued). However, the transfer of those risks would not be a reinsurance contract held unless significant insurance risk is also transferred, since the exception applies only to the entity issuing the contract.
- Even if a reinsurance contract does not expose the issuer of the contract to the possibility of a significant insurance loss, the contract is still deemed to transfer significant insurance risk if it transfers substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts (paragraph B19). Therefore, a reinsurance contract that meets this criterion can be considered as insurance contracts for both the entity issuing the contract and the entity that holds the reinsurance.
- • Contracts need not be written in the traditional form of an insurance contract or reinsurance contract for IFRS 17 to apply. Rather it is the nature of the event that triggers a payment that determines if IFRS 17 is potentially applicable to a contract. For example, contracts that cover catastrophic events such as weather events and earthquakes that cause losses that are specific to a party to the contract may meet the definition of insurance contracts or reinsurance contracts and be subject to IFRS 17 if the insurance risk is significant. However, where the losses to be reimbursed are not specific to a party to the contract, for example a unitized cover determined

by an index, this would not be considered insurance risk and therefore is not an insurance contract or reinsurance contract.

The rest of this chapter is applicable only to reinsurance classified as insurance contracts under IFRS.

Reinsurance Held – (Questions 9.3 – 9.17)

9.3. How is reinsurance held presented in the IFRS statement of financial position and statement of financial performance?

Where an entity has entered into reinsurance contracts to cede insurance risk associated with underlying insurance contracts (either direct insurance contracts or reinsurance contracts issued), the reinsurance held contracts are recognised and presented on the statement of financial position separately from the underlying insurance contracts (paragraph 78).

The measurement values of groups of reinsurance held contracts are aggregated at the portfolio level. These values are recognized and presented as portfolios of reinsurance contracts held that are assets and portfolios of reinsurance contracts held that are liabilities.

For the statement of financial performance, the income and expense from reinsurance held are shown separately from the expenses and income of the underlying insurance contracts (paragraph 82). An entity is also permitted to present the income and expense from a group of reinsurance contracts held as a single amount or separately as income and expense item (paragraph 86). Specifically, paragraph 86 states that

> *An entity may present the income or expenses from a group of reinsurance contracts held (see paragraphs 60-70A), other than insurance finance income or expense, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount. If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premium paid, it shall:*
>
> *a) treat reinsurance cash flows that are contingent on claims on the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract held;*
>
> *b) (b) treat amounts from the reinsurer that it expects to receive that are not contingent on claims of the underlying contracts (for example some types of ceding commissions) as a reduction in the premiums to be paid to the reinsurer;*
>
> *(ba) treat amounts recognised relating to recovery of losses applying paragraphs 66(c)(i)–(ii) and 66A–66B as amounts recovered from the reinsurer; and*
>
> *c) not present the allocation of premiums paid as a reduction in revenue.*

These requirements have implications for some common reinsurance features. Profit commissions would be deducted from revenue if not contingent on claims experience, or

included in claims if contingent on claims experience. Mandatory reinstatement premiums would be recognized as a reduction in claims.

9.4. Does reinsuring insurance contracts impact the recognition of the underlying insurance contacts?

No. Reinsurance does not impact the recognition of the underlying insurance contracts. As per paragraph 75, "when an entity buys reinsurance, it shall de-recognise the underlying insurance contract(s) when, and only when, the underlying insurance contract(s) is or are extinguished".

9.5. Does reinsuring insurance contracts impact the measurement of the underlying insurance contracts on the IFRS balance sheet?

Under IFRS 17, insurance contracts issued by an entity are measured on a gross of reinsurance basis. Estimates of the future cash flows of a group of underlying insurance contracts would be the same regardless of whether there is reinsurance held associated with these obligations.

For the risk adjustment of a group of underlying insurance contracts, the entity's approach to diversifying its risk exposure, including the potential use of reinsurance, could impact the gross risk adjustment. This does not necessarily imply a direct linkage between the gross risk adjustment on underlying insurance contracts and the risk adjustment related to these underlying contracts.

Other than a potential difference in the risk adjustment, the CSM of a group of underlying insurance contracts would also be the same regardless of whether there is reinsurance held associated with these obligations. Note that the converse is not true, as the CSM of reinsurance held contracts can be impacted by the measurement of the underlying insurance contracts if the underlying insurance contracts are onerous (see question 9.8).

9.6. How are reinsurance contracts held measured?

Except for contracts under the PAA, the measurement of reinsurance held follows the same GMA as for insurance contracts generally, and is represented by the fulfilment cash flows associated with the reinsurance held contract plus a CSM. In principle, the measurement of the fulfilment cash flows and CSM of reinsurance held is separately determined from the measurement of the same items of underlying gross insurance contracts, though there are some linkages (see questions 9.7 through 9.10).

With respect to the estimate of future cash flows, paragraph 63 requires consistency between the assumptions used in the measurement of the reinsurance contracts held and in the measurement of the underlying gross insurance liabilities (see question 9.9).

As well the fulfilment cash flows for reinsurance contracts held will need to reflect the possibility of non-performance by the reinsurer (see question 9.11).

With respect to the risk adjustment, a different definition of the risk adjustment is used for reinsurance contracts held that replaces the general definition used for insurance contracts (see question 9.10).

With respect to the CSM, there are specific additional considerations for reinsurance contracts held, including the possibility for the CSM to be both positive and negative, and a linkage between the measurement of underlying insurance contracts and the CSM on reinsurance contracts held in the case where the underlying contracts are onerous (see question 9.8).

9.7. Does the asset or liability for reinsurance held have a CSM?

Assuming the PAA is not being used, and the underlying insurance contracts covered are not onerous, a CSM is determined for reinsurance contracts held using a similar approach as for other insurance contracts. However, there is a key difference in that the CSM can both reduce the reinsurance held asset (i.e., present value of reimbursements from the reinsurance contract exceed the present value of reinsurance premiums) and therefore defer recognition of gain from the reinsurance contract, or reduce the reinsurance held liability (i.e., present value of reinsurance premiums exceeds the present value of reimbursements from the reinsurance contract) and therefore defer recognition of the cost from the reinsurance contract. In other words, in most circumstances, the CSM for reinsurance contracts held will defer the gain from, or the cost of, reinsurance contracts held.

This means that the concept of an 'onerous' reinsurance held contract does not exist (see paragraphs 29 (b), 61 and 65). For reinsurance contracts held, the concepts of 'profitable' and 'onerous' contracts are replaced with 'net gain' and 'net cost' of reinsurance contracts respectively. The rationale is that a net loss from the reinsurance contract would usually represent a commercial expense of purchasing reinsurance and would normally be spread over the period in which the service is received. As a consequence, there is no loss component associated with the 'net cost' reinsurance contracts held.

A key consideration specific to reinsurance held is that the CSM for reinsurance held can be impacted by the measurement of associated underlying insurance contracts when the underlying insurance contracts are onerous (see question 9.8).

9.8. How is measurement (i.e., CSM) impacted when there is reinsurance held against a group of underlying insurance contracts that are onerous?

Where an entity recognizes a loss on a group of underlying insurance contracts because the underlying insurance contracts are onerous, the entity is required to offset this by recognising a gain on reinsurance contracts held. The offset is made through adjusting the CSM on the reinsurance contracts held. A different approach is followed for losses on a group of underlying contracts at initial recognition of the underlying contracts versus losses, or reverses of losses, at subsequent measurement.

Losses on a group of underlying contracts at initial recognition: Where an entity recognises a loss on underlying insurance contracts because the underlying contracts are onerous at initial recognition, the entity simultaneously recognises a gain on the reinsurance contracts held by adjusting the CSM of the reinsurance contracts held. The quantum of the CSM adjustment is the loss recognized on the underlying contracts multiplied by the percentage of claims on the underlying contracts that the entity has

expects to recover from the reinsurance contracts held. If further contracts are subsequently added to this onerous group of underling contracts, this same approach is applied. (paragraphs 66(ba), 66A, 66B, B119C, B119D).

Losses or reversals of losses on a group of underlying contracts at subsequent measurement: The approach applied for losses or reversals of losses at subsequent measurement is different from the approach applied for losses at initial recognition. At subsequent measurement, where changes in the fulfilment cash flows do not adjust the CSM on underlying contracts because the group of underlying contracts is onerous, then the entity similarly does not adjust the CSM on the reinsurance held for changes in fulfilment cash flows associated with these same underlying insurance contracts (paragraph 66 (c) (i) and 66B). For cases where an entity groups together onerous underlying contracts covered by reinsurance contracts held and other insurance contracts not covered by the reinsurance contracts held then the entity is to use a systematic and rational method to determine the portion of the losses arising on the group of underlying insurance contracts which are covered by the reinsurance contracts held (paragraph B119E).

The CSM adjustment determined above is called a loss recovery component in the IFRS 17 standard (paragraph 66B). After a loss recovery component has been established, the loss recovery component is adjusted in subsequent periods to reflect changes in the onerous group of underlying insurance contracts. No specific method is prescribed for this adjustment, however the carrying amount of the loss recovery component cannot exceed the portion of the carrying amount of the onerous group of underlying insurance contracts that the entity expects to recover from the related group of reinsurance contracts held (paragraph B119F).

The reversals of a loss recovery component in a period determined above are reflected in the measurement of the CSM of the group of reinsurance contracts held in the period, unless those reversals reflect changes in the fulfillment cash flows of the group of reinsurance contracts held (paragraph 66 (bb)).

If a reinsurance contract held is accounted for under the PAA, the same general approach is applied, however, the adjustments are made to the asset for remaining coverage rather than the CSM as the PAA does not have a CSM component (paragraphs 70A and 66c(ii)).

Specific guidance is also given in the standard to handle the special situations of business acquired through business combinations or portfolio transfer. Which follow the general approach above (paragraphs B95B, B95C, B95D)

Another purpose of the loss recovery component is to determine the amounts that are presented in profit or loss as reversals of recoveries of losses from reinsurance contracts held and are consequently excluded from the allocation of premiums paid to the reinsurance and instead treated as amounts recovered from the reinsurer (paragraphs 66B, 86(ba)).

9.9. Would the future cash flow assumptions for business covered by reinsurance held be the same as the future cash flow assumptions used for the same business in the underlying insurance contract valuation?

Paragraph 63 states that "*the entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurancecontracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts.*" This requirement for consistency applies to all assumptions, insurance and financial. Consistent does not mean all assumptions have to be identical, as there may be assumptions where the assumptions used for measuring the underlying insurance contract are not valid for reinsurance contracts held.

For example, assumptions related to policyholder behaviour or insured decrements (, mortality rates, morbidity rates, policyholder claims assumptions) would be consistent between the underlying insurance contract valuation and where these assumptions are used to measure the value of the reinsurance held. Other assumptions, such as expenses may be different. Discount rates will reflect differences between the liquidity characteristics of the reinsurance contracts held versus the underlying insurance contracts.

In addition, other variables and determinants of the cash flows, including the contract boundary, may be different depending on the terms of the reinsurance. See also question 9.13.

9.10. How is the reinsurance held risk adjustment for non-financial risk determined?

A specific definition for the determination of the risk adjustment for reinsurance contracts held is provided that replaces the general definition in paragraph 37 used for insurance and reinsurance contracts issued in the standard. Under the definition for reinsurance held, the risk adjustment for non-financial risk represents the amount of non-financial risk being transferred by the holder of a group of reinsurance contracts to the issuer(s) of those contracts (paragraph 64).

The risk adjustment for the reinsurance held can therefore conceptually be thought of as the difference in the risk position of the entity with (i.e., net position) and without (i.e., gross position) the reinsurance held. As a result, the risk adjustment for the reinsurance held could be determined based on the difference between these amounts.

Another possibility to determine the risk adjustment for reinsurance held is to consider the cost of reinsurance as an indicator of the entity's view of the compensation that would be required to keep (i.e., not reinsure) the risk. Under this view, the cost of reinsurance would be an estimate of the risk adjustment for the reinsurance held.

For reinsurance held, because the risk adjustment for reinsurance held is defined based on the amount of risk transferred to the reinsurer, the risk adjustment for reinsurance held will either increase the reinsurance contract asset or reduce the reinsurance contract liability. This has the opposite effect from the risk adjustment on insurance contracts

issued. For example, the release of the risk adjustment on reinsurance contracts held in a reporting period will reduce reported profit rather than increase it.

9.11. How is counter party risk of non-performance by the issuer of reinsurance contracts reflected in reinsurance contracts held?

In determining the fulfillment cash flows, the present value estimates of future cash flows to be received for the reinsurance contracts held are reduced by an allowance for reinsurance counter party failure to fulfill the contractual obligations (paragraph 63 and further clarified in BC308). There are two possible approaches, the first to adjust the cash flows directly and the second to adjust the discount rates to reflect this risk.

The allowance would reflect not only potential reinsurance counter party failure due to defaults (i.e., credit events), but would include allowances for disputes resulting in reduced payments as well as reflecting the effects of collateral. Default allowances requires an estimate of expected credit losses, which would normally reflect the current financial condition and credit standing of the reinsurance counter party. If the allowance for non-performance in the fulfillment cash flows is changed, then the change does not adjust the contractual service margin (paragraph 67).

With respect to the risk adjustment, the requirement in paragraph 64 that the risk adjustment for non-financial risk represents the amount of risk being transferred by the entity to the reinsurer has been interpreted two ways with respect to non-performance risk. An interpretation which follows directly from the definition of the risk adjustment for reinsurance contracts held in paragraph 64 is that counter party risk is not considered in the risk adjustment as this is not a risk formally transferred by the contract. An alternative interpretation is that counter party risk is appropriate to consider in the risk adjustment since this is a risk that, at an entity level, exists for the party with the reinsurance held as a result of entering the contract to transfer risk. Under this alternative interpretation it would be important to ensure there is no double counting for credit risk between the risk adjustment and the estimate of future cash flows.

9.12. Would grouping of contracts for reinsurance held be the same as contract grouping used for the same business in the gross insurance liabilities?

The grouping of reinsurance held contracts may be different than the contract grouping for the corresponding underlying contracts.

A reinsurance contract is a single contract, even though it may consist of cessions of many underlying insurance contracts.

Under IFRS 17, contracts are normally grouped, although it is permissible to have one contract in a group. Because certain reinsurance contracts already aggregate risk and consolidate underlying contract exposures, it may in some circumstances make sense to make use of the permission to have one (reinsurance) contract in a group.

The presumption in IFRS 17 is that the legal form of a contract would generally represent a single contract. Unless a contract contains components that would be within the scope

of another standard if they were separate contracts, the contract is contemplated as the most basic unit of account (i.e., lowest level of aggregation).

There may be circumstances where the legal form of a reinsurance contract is not sufficiently granular to reflect the substance of its contractual rights and obligations. In this circumstance, a contract might be disaggregated into components. Disaggregating a contract is not an accounting policy choice and would need to be based on relevant facts and circumstances necessary to override the presumption of the contract of as the most basic unit of account. Relevant considerations in the assessment of disaggregating a contract would include (i) whether the risks covered by the contract are independent, (ii) whether components of the contract can lapse separately (iii) whether components of the contract can be priced separately. None of these factors individually can be considered determinative and need to be assessed together with all the relevant facts and circumstances.

For the issuer of underlying contracts, the fact that a reinsurance contract held covers underlying contracts that the issuer has included in different groups of contracts and / or portfolios is not, by itself, sufficient to conclude that the reinsurance contract held does not reflect the substance of its contractual rights and contractual obligations and that unbundling is warranted.

The grouping requirements for insurance contracts outlined in paragraphs 14 – 24 also apply for reinsurance, with the exception that for reinsurance contract held there is an additional paragraph, 61, to account for the fact that reinsurance contracts cannot be onerous. Paragraph 61 states that "*An entity shall divide portfolios of reinsurance contracts held applying paragraphs 14 – 24, except that the reference to onerous contracts in those paragraphs shall be replaced with a reference to contracts on which there is a net gain on initial recognition. For some reinsurance contracts held, applying paragraphs 14 – 24 will result in a group that comprises a single contract*".

9.13. What are the considerations when a reinsurance held contract may cover multiple years of underlying insurance contracts or risk attachments?

For reinsurance held, a single reinsurance held contract may cover multiple years of underlying contract cessions or risk attachments. Some reinsurance held contracts, in addition to covering existing risks / cessions, are open to accepting future cessions / risk attachments. This leads to the question, when measuring the value of an existing group of reinsurance held contracts at a point of time T, what future cessions / risk attachments after time T are reflected in the future cash flows.

There are several relevant paragraphs in the standard.

Paragraph 33 states that

> *"An entity shall include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group"*

Paragraph 34 states that "*Cash Flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in*

which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services (see paragraphs B61-B71). A substantive obligation to provide services ends when:

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

b) both of the following criteria are satisfied: (i) The entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and (ii) the pricing of the premiums for coverage up to the date when the risks are assessed does not take into account the risks that relate to periods after the reassessment date"

The above wording in paragraph 34 is written from the perspective of a directly written insurance contract and needs to be interpreted for reinsurance held contracts. AP03 February 2018 IASB TRG provided the view that, for reinsurance contracts held, cash flows are considered within the contract boundary for a reinsurance held contract if they arise from substantive rights and obligations that exist during the reporting period in which the ceding entity is compelled to pay amounts to the reinsurer or in which the entity has a substantive right to receive services from the reinsurer.

Essentially this means that the contract boundary for a reinsurance held contract under this interpretation would be the maximum of the point to which the ceding entity can be compelled to keep the coverage on substantively unchanged terms, and the point at which the ceding entity can compel the reinsurer to provide services on substantively unchanged terms. This duality of conditions that need to be met to reach a contract boundary is an important consideration in establishing the contract boundary.

The implications of the above paragraphs might best be illustrated by examples.

Consider two possible non-proportionate reinsurance held contracts initially recognized in period T, each, for the sake of simplicity, considered a separate "group" of 1 contract.

Contract A is a reinsurance contract held where existing risks are covered until they expire at fixed rates guaranteed by the reinsurance contract. The contract is open to new risk attachments but the reinsurer and ceding insurer can terminate the addition of new risks at any time.

This contract would be treated as a contract with a contract boundary at the reporting date since the ceding entity cannot be compelled to continue the contract beyond the reporting date, nor does the entity have the right to compel the reinsurer to continue the coverage beyond the reporting date.

The implication is that at the valuation date at the end of period T, the entity would project future cash flows related to the risk attachments during period T, and would not project future risk attachments since there is no contractual obligation from either party

to continue to accept new risks into the contract. At time T+1, the cash flows of the risks that attach between T and T+1 would be treated as a separate and new contract for IFRS 17 purposes. (i.e., there are two contracts for IFRS 17 purposes: one for risks that attached during period T, and one for risks that attach during period T+1). See question 9.20 for further discussion of the contract boundaries.

Contract B is a reinsurance contract held where existing risks are covered until they expire at guaranteed rates. The contract is open to new risks at fixed rates guaranteed by the reinsurance contract for at least the next 3 years, after which the reinsurer and ceding entity can terminate the addition of new risks.

The contract would be treated as a contract with a 3-year contract boundary since that is the date at which the ceding entity can no longer be compelled to continue the contract or have the right to compel the reinsurer to provide services.

The implication is that at the valuation date at the end of period T, the entity would project future cash flows related to the existing risk attachments at time T, and would also project future risk attachments for risks to the end of the 3 year guarantee period because the reinsurer has contractually agreed to accept those risks by locking in guaranteed rates. At time T+1, the cash flows of the reinsurance contract held would include the projections of cash flows for all risk attachments up to time T+1, including true up of cash flows for actual versus expected for risk attachments between T and T + 1, plus updated projected cash flows for future risk attachments to the end of the remaining time in the 3-year guarantee period.

There are other implications that might be considered.

- The future cash flows included may impact the ability to use the PAA for the reinsurance contract held. Where a reinsurance contract is intended to cover multiple years of cessions / risk attachments, it may prove more difficult to prove
- eligibility to apply the PAA for contracts where the coverage period for the underlying contract is only 1 year, but new risks attach after the inception date.
- The IFRS 17 application guidance states that, when determining the discount rates for initial recognition, "*an entity may use weighted-average discount rates over the period that contracts in the group are issued, which applying paragraph 22 cannot exceed one year*" [paragraph B73]. When a reinsurance contract covers multiple cession years and all cession years are considered as part of the same contract for IFRS 17 purposes, the locked-in discount rates for the reinsurance contracts held could be different than the locked-in discount rates for the underlying contracts.

9.14. Are there special considerations for the initial recognition of proportionate reinsurance held?

According to paragraph 62A, the recognition of a group of reinsurance contracts held that provide proportionate coverage is delayed until the date that any underling insurance contract is initially recognised, if that date is later than the beginning of the coverage period of the group of reinsurance contracts held.

9.15. What is a proportionate reinsurance coverage?

Proportionate reinsurance coverage is not defined in the IASB 17 standard. One interpretation is that proportionate coverage is where the amount of reinsurance coverage for each underlying insurance contract under related reinsurance contract held is a fixed percentage of each claim incurred on underlying insurance contracts, but where the fixed percentage can vary by underlying insurance contract.

9.16. Can the PAA be used for reinsurance contracts held?

Yes, reinsurance contracts held are eligible for the PAA provided they meet the criteria to use the approach (paragraph 69). The criteria to use the PAA, such as coverage period of the contracts in the group, need to reflect the contractual terms of the reinsurance contracts held in the group, and not the underlying insurance contracts.

9.17. Are there potential economic mismatches between the measurement of a reinsurance contract held and the measurement of associated underlying insurance?

Yes, there are several areas of possible economic mismatch. Significant areas of mismatch include the following:

For reinsurance contracts held, the contract boundary definition means that the measurement of reinsurance contracts held may need to extend to include cash flows associated with future projected cessions up to the point at which the reinsurance contract can be exited for new business. The measurement of underlying insurance contracts will not include any cash flows related to these future projected cessions, since the underlying insurance contracts are only recognized as written. This creates a mismatch in terms of timing of recognition of cessions versus underlying contracts.

Underlying contracts may use the Variable Fee approach, while associated reinsurance held contracts are not eligible to use the Variable Fee approach. This can create measurement mismatches, however, for financial risks this can be mitigated as the entity can apply the risk mitigation option for insurance contracts with direct participation features when the entity uses reinsurance contracts held to mitigate financial risks.

Underlying contracts may have different liquidity characteristics than reinsurance contracts held, leading to different discount rates.

Other mismatches may also be present, based on the specific circumstances.

9.18. If a reinsurance contract held is used to mitigate financial risk from insurance contracts, can this risk mitigation impact be reflected in the accounting?

Yes, under paragraph B116, when an entity can demonstrate that it uses reinsurance contracts held to mitigate financial risk arising from underlying insurance contracts with direct participation features it can elect to apply the accounting outlined in paragraph B115 in order to reflect the risk mitigation. This allows some or all of the effects of financial risks that would otherwise be reflected in CSM of the underlying insurance contracts to not be reflected in CSM and instead be recognized in a way that is consistent

with how the entity recognizes such effects for the reinsurance contracts held (Paragraph B117A).

Reinsurance Held and Reinsurance Issued (Questions 9.19 – 9.24)

9.19. Would the contract boundary used for reinsurance issued and reinsurance held for the same contract necessarily be the same?

The contract boundary would normally be the same for both parties. This follows from an IASB staff interpretation that the criteria for establishing the contract boundary for both reinsurance issued and reinsurance held is determined by considering the substantive rights and obligations of both parties to the contract.

9.20. How are contractual options such as recapture, cancellation, or commutation treated in estimating reinsurance cash flows?

As a first step, any elements that are embedded derivatives are separated and subject to IFRS 9 (paragraph 11).

The cash flows would then reflect the characteristics of the reinsurance contract (excluding the embedded derivatives). The contracts may contain options that may be exercised at the discretion of the party holding or issuing the contract. The cash flows would take into account the expected behaviour of the parties to the contract in exercising these options on a basis consistent with the assumptions used in the measurement.

The rights of the parties holding or issuing the contract also would be taken into account in determining the contract boundary.

9.21. Can reinsurance contracts qualify as insurance contracts with direct participation features?

Reinsurance contracts, including both reinsurance held and reinsurance issued, cannot qualify as insurance contracts with direct participation features (paragraph B109).

9.22. How is continuation of a reinsurance contract past a contract boundary be treated?

Under termination provisions common in many reinsurance structures, it will not be uncommon under IFRS 17 to have situations where a reinsurance contract is extended beyond the original IFRS 17 contract boundary through the exercise of contractual terms – for example, continuation of a fully cancellable reinsurance contract with guaranteed premiums past the cancellation exercise date which created the boundary.

Relevant paragraphs in the standard to address this circumstance include the following:

- Paragraph 35 which states that "*an entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. Such amounts relate to future insurance contracts*",
- Paragraph B64 which states that "*in determining the estimates of future cash flows at the end of a reporting period, an entity shall reassess the boundary of an*

insurance contract to include the effect of changes in circumstances on the entity's substantive rights and obligations".

- Paragraphs 72 and 73 for treatment of various forms of contract modifications, including that statement in paragraph 72 that "*the exercise of a right included in the terms of a contract is not a modification*.

This topic was addressed in detail at the September 2018 IASB TRG meeting (AP05), The predominant interpretation was that, pursuant to Paragraph 35, with the exception noted in the next paragraph, the continuation of a contract past its original contract boundary would be treated as a new contract with a new contract boundary for any risks that attach after that point.

Paragraph B64 would apply and the original contract boundary would be extended (as opposed to a new IFRS 17 contract being recognized) only when restrictions on an entity's practical ability to assess risk and reprice have changed.

9.23. How are profit participation features (experience refund provisions) in reinsurance contracts treated?

Profit participation features (also known as experience refund provisions) in reinsurance contracts are designed to return a portion of the premium paid to an entity ceding insurance contract risk based on the performance of the underlying insurance contracts.

Profit participation features are modelled in the fulfilment cash flows, and reflect the amounts that would be expected to be paid based on the expected cash flow assumptions. In some reinsurance arrangements profit participation features are based on the combined profitability of multiple reinsurance contracts between issuers and holders of reinsurance contracts rather than on the performance of reinsurance contracts individually. In these situations, the interactions across contracts would normally be appropriately captured in the fulfilment cash flows and CSM. Of relevance, IFRS 17 states that *a set of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the set or series of contracts as a whole* (paragraph 9). Therefore, combining risks that would otherwise be included in different IFRS 17 contracts could be appropriate.

Profit participation features can have varied contractual structures. In some instances, the profit participation feature may include elements that meet the attributes of an investment component (i.e., an amount that is repaid to the policyholder in all circumstances) in which case the amounts that have the attributes of an investment component should be shown as an investment component and excluded form both reinsurance premiums paid and reinsurance recoveries

An example of a profit participation feature that may meet the definition of an investment component is a structure where an initial profit commission of x% of reinsurance premium is paid by the issuer of a reinsurer contract to the holder of a reinsurance contract, and the reimbursement of claims under the reinsurance contract is

(100-x)% of claims up to the reinsurance premium, and 100% of the excess. In this example, the x% of reinsurance premium may meet the definition of an investment component.

Profit participation features in reinsurance contracts are normally highly integrated with the performance of the underlying insurance contracts, and could not be sold as stand-alone products. In these circumstances, even though the profit participation features may be investment components, they would not be treated as distinct investment component as they do not fulfil the requirements of IFRS 17 B31. It. They would therefore be treated as a non-distinct investment component.

9.24. How are funds withheld features in reinsurance contracts treated?

IFRS 17 prohibits separating non-insurance components when not required (Paragraph 13 and BC 114). As a result, cash flows for funds withheld components would be included in the cash flows of the reinsurance contracts for measurement. As a consequence, the measurement values of the reinsurance contracts would be net of funds withheld.

For many preparers, this will be a change in treatment from IFRS 4, which did permit voluntary separation of such features, which led to reporting of separate funds withheld balances and measurement values for reinsurance contracts gross of funds withheld balances.

Reinsurance Issued (Questions 9.25 – 9.27)

9.25. How is reinsurance issued presented on the IFRS balance sheet?

Where an entity has entered into reinsurance contracts to assume risk and obligations, the value of these contracts is shown on the balance sheet as part of the insurance contract liabilities or assets rather than with reinsurance contract held assets or liabilities. Contracts are aggregated at the portfolio level for presentation as assets or liabilities.

9.26. Are there special considerations for reinsurance issued liabilities?

In general, reinsurance issued business, once classified as insurance risk, is treated consistently in approach with all other gross insurance liabilities issued.

Data issues are frequently more prevalent for reinsurance issued business than for underlying insurance business, as the reinsuring entity is further removed from the underlying risks than the ceding entity, and is usually reliant on the ceding entity for underlying data on insured risks. This means that there is frequently more use of approximations both in terms of data and modeling approach.

9.27. What are the considerations when a reinsurance issued contract may cover multiple years of underlying insurance contracts or risk attachments?

For reinsurance issued, a single reinsurance contract might cover multiple years of underlying contract cessions or risk attachments. In addition to covering existing risks / cessions, contracts might be open to accepting future cessions / risk attachments.

The considerations and relevant paragraphs in the standard are similar to reinsurance held as covered in question 9.13.

Section C – Uses of fair value

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

- Fair Value – Chapter 10
- Business Combinations and Portfolio Transfers – Chapter 11
- Transition – Chapter 12

Chapter 10 discusses the principles of how to determine the fair value of insurance contracts in the context of the more general guidance on fair value measurement found in IFRS 13 Fair Value Measurement and of common insurance industry practices.

Chapter 11 discusses the requirements under IFRS 17 when accounting for insurance contracts or liabilities for incurred claims acquired in a business combination or a portfolio transfer, and in particular the need to use the fair value of the contracts as the initial consideration.

Chapter 12 discusses the one-time event of presenting statements applying IFRS 17 for the first time with a section for each of the three transition approaches described in IFRS 17 -- the retrospective approach of IAS 8 and the alternative approaches introduced by IFRS 17, modified retrospective and fair value.

Chapter 10 – Fair Value

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

10.A. What does this chapter address?

This chapter considers the fair value measurement of contracts in IFRS 17 in the context of the more general guidance on fair value measurement found in IFRS 13 *Fair Value Measurement* ("IFRS 13") and of common insurance industry practices.

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

Paragraphs 39 and B94 specify the use of fair value when contracts are acquired in a business combination. Paragraphs C5 and C20-C24 discuss the use of fair value on transition to IFRS 17.

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

Chapter 11 – *Business Combinations and Portfolio Transfers*, Chapter 12 – *Transition*, and Chapter 13 – *Embedded Derivatives*.

10.1. When is fair value measurement applied to insurance contracts[25]?

In IFRS 17, fair value measurement is used:

a. at initial recognition of contracts acquired in a business combination. The fair value is determined as of the date of the acquisition (see Chapter 11 – Business Combinations and Portfolio Transfers); and

b. on transition to IFRS 17 when the fair value approach (paragraph C5(b)) is selected. The fair value is determined as at the transition date, which is usually the beginning of the annual period immediately preceding the date of initial application of IFRS 17 (see Chapter 12 – Transition).

For insurance contracts acquired in a business combination, IFRS 17 states that the fair value of the contracts is the consideration received for those contracts (paragraph B94). Business combinations may include other assets and liabilities, in which case the consideration received for the insurance contracts may need to be estimated, as the business combination or purchase agreement may not list separate prices for separate components of the transaction (see question 10.4).

This chapter addresses fair value measurement in the context of business combinations where the consideration received for the insurance contracts is estimated and in the context of transition to IFRS 17. This chapter may also be useful in the context of contracts acquired in a transaction that does not form a business combination where

[25] The term "insurance contracts" as used in this chapter includes all contracts in the scope of IFRS 17.

the fair value of groups of contracts is used to allocate the total consideration for the entire block of contracts to the groups.

Fair value measurement is also used to measure embedded derivatives that are separated from insurance contracts and for financial instruments issued by insurers which are not in the scope of IFRS 17. These applications of fair value measurement are not addressed in this chapter.

10.2. What is the fair value of insurance contracts?

IFRS 17 does not provide guidance on determining the fair value of insurance contracts except as noted below in relation to a demand feature. With certain exceptions, IFRS 13 provides guidance when other IFRSs require fair value measurement. Insurance contracts are not specifically excluded from the scope of IFRS 13, and, consequently, IFRS 13 is relevant to insurance contracts. IFRS 13 does not provide specific guidance on insurance contracts; hence the entity is left to consider how to apply the guidance in IFRS 13 to insurance contracts.

Paragraph 9 of IFRS 13 defines fair value as:

> *"…the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."*

A comprehensive discussion of IFRS 13 is beyond the scope of this chapter. This chapter does include a discussion of the relevant considerations of IFRS 13 as they apply to insurance contracts.

IFRS 13 Fair Value Measurement	
IFRS 13 requirement	Application to insurance contracts
The price may be observable, but if it is not, it must be estimated (paragraph 2 of IFRS 13).	Prices for insurance contracts are rarely observable. In most cases, the fair value of insurance contracts needs to be estimated. See question 10.3.
Fair value is a market-based measurement, not an entity-specific measurement (paragraph 2 of IFRS 13). Fair value should be measured using the assumptions that market participants would use (paragraph 22 of IFRS 13).	Measurement from the perspective of a market participant may be different from the measurement of fulfilment cash flows (paragraph 57 of IFRS 13). See questions 10.4 and 10.5.

IFRS 13 Fair Value Measurement	
IFRS 13 requirement	Application to insurance contracts
The objective is to estimate the price under current market conditions (paragraph 2 of IFRS 13).	Current market conditions refer not only to general economic conditions (e.g., interest rates) but also to the state of the market for transfers of insurance contracts, which may be difficult to determine. See question 10.4.
The price is based on a hypothetical transaction in the principal market or, if there is no principal market, in the most advantageous market (paragraph 16 of IFRS 13).	The distinction between the principal market and the most advantageous market for insurance contracts may not make a difference. In some jurisdictions, market participants might be limited to other insurers or reinsurers that would be able to complete a transaction.
The unit of account is determined in accordance with IFRS 17 (paragraph 14 of IFRS 13) and is the level at which an asset or a liability is aggregated or disaggregated for recognition purposes (Appendix A of IFRS 13).	In IFRS 17, the unit of account for recognition and measurement of the liability is groups of insurance contracts ("groups"), as that is described in IFRS 17 (see Chapter 5 – Level of Aggregation). The fair value would similarly be determined by groups.
When a price for a liability is not available and the identical item is held by another party as an asset, fair value is measured from the perspective of market participant that holds the asset (paragraph 37 of IFRS 13).	For this purpose, policyholders are not considered to be market participants. Furthermore, the price associated with a viatical settlement would not be relevant to the measurement of fair value of a group.
Non-performance risk, (which includes consideration of credit standing) is reflected in the fair value measurement of a liability (paragraph 42 of IFRS 13).	Fair value measurement reflects non-performance risk of the entity, however, the measurement of fulfilment cash flows under IFRS 17 does not. For reinsurance contracts held, IFRS 17 requires the credit standing of the reinsurer be reflected (see question 10.5).

IFRS 13 Fair Value Measurement	
IFRS 13 requirement	Application to insurance contracts
There is a demand feature on the fair value of financial liabilities (paragraph 47 of IFRS 13).	IFRS 17 states that a demand feature does not apply when the fair value of insurance contracts is determined (paragraph B94, business combinations, and C20, transition). See question 10.5.
When price is not observable, the entity measures fair value using another valuation technique that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs (paragraph 3 of IFRS 13). An entity shall use valuation techniques consistent with one or more of the market approaches, the cost approach, and the income approach to measure fair value (paragraph 62 of IFRS 13).	Actuarial valuation techniques (such as embedded values), actuarial appraisals, and other present values techniques appear to be consistent with the income approach to measure fair value (paragraph B19 of IFRS 13) but may need to be adapted for the purpose of IFRS 17 (see questions 10.5 and 10.6).
IFRS 13 has a hierarchy of inputs to valuation techniques used to measure fair value (paragraphs 72–90 of IFRS 13): • Level 1: Observable quoted prices, in active markets; • Level 2: Quoted prices are not available, but the input is based on observable market data; and • Level 3: Unobservable inputs. The asset or liability being measured is characterized by the highest input level.	Fair value measurement of insurance contracts would usually require Level 3 inputs, especially with respect to non-market variables, and hence are likely to be characterized as Level 3.
IFRS 13 has a number of disclosure requirements related to fair value measurement after initial recognition (paragraphs 91–99 of IFRS 13).	Fair value measurement of insurance contracts only takes place at an initial date (i.e., acquisition date or date of first reporting on transition), and, therefore, the disclosure requirements of paragraphs 91–99 of IFRS 13 do not apply.

10.3. How is the fair value of insurance contracts calculated?

IFRS 13 does not prescribe a valuation technique. In the context of a business combination, the entity may have an analysis of value that can form the basis of the fair value measurement, perhaps requiring adjustment to be consistent with the objective of an exit price.

The application guidance in Appendix B of IFRS 13 provides information about other possible valuation techniques. Among them are present value techniques (paragraphs B12-B30 of IFRS 13) for the fair value measurement of a stream of cash flows. These techniques share many characteristics with the IFRS 17 guidance on measuring fulfilment cash flows (e.g., paragraph B23 of IFRS 13) and therefore are candidates for the estimation of fair value of insurance contracts under IFRS 17.

An approach to estimating fair value of a group using a present value technique is to adjust the fulfilment cash flows of the group in order to fulfil the objectives of IFRS 13. Adjustments to reflect the perspective of market participants (i.e., to move to an exit price) are discussed in question 10.5.

IFRS 13 does not specify that a fair value estimate be before-tax or after-tax. However, there is a general admonition that valuations should be internally consistent, with specific mention that this general principle means that after-tax cash flows are discounted with an after-tax rate, and pre-tax cash flows are discounted with a pre-tax rate.

10.4. How would IFRS 13 Level 1 and 2 inputs (observable market information) be applied?

Market transactions involving insurance contracts may provide information about fair value, and, if so, the estimated fair value is likely to be consistent with observable market information where available. It is unlikely, however, that a direct relevant market price would be found. Furthermore, the transaction price at which a group is exchanged may include factors (such as those in paragraph B4 of IFRS 13) that would be ignored for the purpose of estimating the fair value of a group. Examples of factors specific to insurance contracts that would be ignored include:

- Expected profits or losses associated with cash flows beyond the boundaries of the insurance contracts in the group;
- Expected profits or losses associated with investment/service components that will be recognized and measured separately from the group; and
- Expense, tax, or other synergies that a particular market participant might expect to realize but that would not be generally available in the principal market.

Information that would be relevant, if reasonably available, might include:

- Market view of expected expenses associated with fulfilling the obligations of the insurance contracts in the group;
- Market view of the cost of risk associated with taking on the obligations of the insurance contracts in the group, and

- Market view of the cost of reinsurance that would be required to take on the obligations of the insurance contracts in the group.

IFRS 13 requires the entity to maximise the use of relevant observable inputs (paragraphs 3, 36, 61 and 67 of IFRS 13). However, an entity need not undertake exhaustive efforts to obtain information about market participant assumptions and may use information that is reasonably available (paragraph 89 of IFRS 13).

10.5. When using a present value approach, what adjustments would be made to fulfilment cash flows to satisfy the objectives of fair value measurement?

When using a present value approach, the fair value of a group of insurance contracts can be seen as the fulfilment cash flows adjusted to take into account the perspective of market participants (i.e., move to an exit price).

Possible adjustments that could be made include the following:

- The discount rates applied to the estimates of future cash flows (paragraph B14(c) of IFRS13) are adjusted to reflect the entity's own credit risk (paragraph B13(f) of IFRS13) and may require adjustment for reinsurer own credit in the case of reinsurance contracts held.
- Where consistent with market practice, the discount rates applied to the estimates of future cash flows are adjusted to reflect the perspective of market participants on the liquidity characteristics of the group of insurance contracts.
- Where different from the entity's view, projected expense cash flows reflect the market view of the expenses associated with fulfilling the obligations of the group of insurance contracts. For example, where consistent with market practice, expense cash flows are increased to cover a reasonable level of general expenses (i.e., expenses not directly attributed to the portfolio to which the group belongs).
- Where different from the entity's view, other assumptions used in cash flow projections are adjusted to reflect the market view. For most assumptions, the market view is likely to be the same as the entity's view because the entity has the best information available and the fulfilment cash flows take into account all relevant available information. However, for assumptions that are not specific to the entity or its contracts (e.g., future population mortality improvement or entity specific synergies), the market view might differ from the entity's view.
- Where different from the entity's view, the risk adjustment for non-financial risk is adjusted to reflect a degree of risk aversion (paragraph B88(b)) consistent with the market view.
- Where different from the entity's view, the degree of diversification benefit (paragraph B88(a)) included in the risk adjustment for non-financial risk is adjusted to be consistent with the market view. As noted in question 10.2, the unit of account for fair value measurement under IFRS 17 is the group.

- Where consistent with market practice and where not otherwise reflected in the estimate of fair value, the risk adjustment for non-financial risk is increased to include the cost of capital on risks not covered in the fulfilment cash flows, including non-observable financial risks.
- Where consistent with market practice and where not otherwise reflected in the estimate of fair value, the fair value is adjusted to reflect expense, tax, or other synergies that would be available in the principal market.
- Where not included in the other points above, the fair value is adjusted to reflect the return that a market participant would require for undertaking the activity (see paragraphs 41 and B31 of IFRS 13), which may be interpreted to include profit margins that a market participant would require for providing insurance coverage and other investment related services attached to the group.

10.6. How do embedded values or appraisal values compare to fair values?

Embedded values or appraisal values are typically determined in the context of a transfer of liabilities together with supporting assets and consider the present value of future expected profits less the cost of capital.

The fair value of insurance contracts under IFRS 17 is the fair value of the liabilities only (i.e., the supporting assets are ignored). Therefore, embedded and appraisal values cannot be used directly as the fair value of a group under IFRS 17, because they measure the profit expected from liabilities together with assets rather than the amount of assets that would be required to take over the obligations (i.e., liabilities) of the contracts.

However, embedded and appraisal value techniques could be adapted to estimate the fair value of the liabilities, for example, by solving for the amount of cash that (with a market view) would be required to provide an embedded value of nil after satisfying the entity's cost of capital and other return requirements. Also, embedded and appraisal value observations can provide some context to help assess the market view of the degree of risk aversion, cost of capital, or other factors affecting fair value measurement (see question 10.5).

10.7. Can a group be onerous on acquisition or transition?

A group would be onerous if the fair value is less than the fulfilment cash flows. This may be unusual under the present value approach described in this chapter, as most of the adjustments noted in question 10.5 contribute to the fair value being higher than fulfilment cash flows. However, there may be circumstances in which market conditions conspire to make the fair value less than the fulfilment cash flows, so this possibility would not be disregarded.

10.8. Are there any special considerations for estimating the fair value of insurance contracts with direct or indirect participation features?

The starting point is typically the same as for contracts without participation features. Adjustments made to fulfilment cash flows (question 10.5) would reflect the participation features of the insurance contracts. In particular, if discount rates applied to cash flows

that vary based on the returns on underlying items have been adjusted to reflect that variability (paragraph B74(b)), the discount rates used for fair value measurement would be similarly adjusted.

Alternatively (equivalently), the fair value of a group could be estimated as the fair value of the groups' share of the underlying items with adjustments as needed to account for the non-participating features of the contracts in the group.

10.9. Are there any special considerations for estimating the fair value of reinsurance contracts held?

The approach is the same as for direct written contracts. The market for reinsurance contracts held would be related to the market for the contracts that are reinsured, as transactions involving reinsurance contracts held are usually part of transactions involving the reinsured contracts. With this perspective, the fair value of a group of reinsurance contracts held can be viewed as the amount that brings the fair value of the reinsured (underlying direct) contracts to the net fair value of the direct contracts combined with the reinsurance contracts held. In other words, the fair value of a group of reinsurance contracts is the difference between the fair value of the underlying direct contracts (ignoring reinsurance) and the fair value of the underlying direct contracts combined with the reinsurance contracts held.

10.10. Should the fair value disclosures of investment contracts with direct participating features be prepared according to IFRS 7?

No, the scope exclusion to paragraph 3(d) of IFRS 7 Financial Instruments: Disclosures is amended to scope out all the contracts within the scope of IFRS 17 Insurance Contracts. However, the disclosure is required for the investment components that are separated from contracts within the scope of IFRS 17 (see paragraph 3(d)(ii) of IFRS 7).

Chapter 11 – Business Combinations and Portfolio Transfers

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

11.A. What does this chapter address?

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

Business combinations under common control are outside of the scope of IFRS 3 and excluded from the scope of the requirements for business combinations in IFRS 17. Business combinations under common control are currently outside the scope of IFRSs and accounted for in different ways. As of October 2020, the IASB has a current project on business combinations under common control.

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

Paragraphs 39, 108, and B93-B95 provide guidance on this topic. Paragraph B5 may be relevant. Appendix D delineates concomitant amendments to IFRS 3.

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

Chapter 10 – Fair Value is directly relevant. Contracts acquired in a business combination or in a portfolio transfer are measured by approaches consistent with the approaches used by the acquiring entity in valuing the acquisition.

11.1. What are the general requirements of IFRS 3 for accounting for a business combination?

Paragraph 4 of IFRS 3 requires the acquisition method of accounting to be applied to business combinations within its scope. The acquisition method views a business combination from the perspective of the acquirer. The acquirer purchases the assets and assumes the obligations of the seller. The measurement of the acquirer's assets and liabilities that existed before the acquisition is not affected by the transaction.

Paragraph 5 of IFRS 3 describes the acquisition method as comprising four steps:

- Identifying the acquirer;
- Determining the acquisition date;
- Recognising and measuring the identifiable assets acquired and the liabilities assumed and
- Recognising and measuring goodwill or a gain from a bargain purchase.

Identifying the acquirer and determining the acquisition date are sometimes complex matters that do not require actuarial expertise. These issues are not in the scope of this chapter. Guidance can be found in paragraph 7 of IFRS 3, which in turn refers to IFRS 10 Consolidated Financial Statements, and in paragraphs B13-B18 of IFRS 3.

This chapter is primarily concerned with step 3 as it relates to insurance contracts and for acquisitions that do not form a business combination. There are some paragraphs and an appendix that provide some information about the other aspects of steps 3 and 4 to help actuaries understand the broader context in which the measurement of insurance contracts assets and liabilities is taking place.

11.2. What is a business combination, and how does it differ from a transfer of insurance contracts?

IFRS 17 does not define the term "business combination". There is guidance for determining if a transaction is a business combination in IFRS 3, as discussed further below.

For the purposes of this chapter, a transfer is a transaction involving contracts in the scope of IFRS 17 that may not constitute a business combination. Although not stated as such, the distinction likely makes no difference to the measurement of the assets or liabilities, but it may affect the goodwill and the tax accounting associated with the transaction.

11.3. What are the general requirements for determining if a transaction is a business combination?

IFRS 3 in effect defines a process that involves:

a. Determining the nature of the transaction (i.e., determining whether it is a business combination or a different type of transaction);

b. Applying the acquisition method of accounting to transactions that are business combinations;

c. Recognising and measuring the identifiable assets acquired and liabilities assumed; and

d. Recognising and measuring goodwill or a gain from a bargain purchase.

The questions in this chapter expand on these topics and related matters.

IFRS 3 (Appendix A) defines a business combination as "A transaction or other event in which an acquirer obtains control of one or more businesses." IFRS 3 goes on to state that transactions referred to as "true mergers" or "mergers of equals" are also business combinations. IFRS 3 also defines a business as: an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or their owners, members or participants. The acquiree is the acquired business and the "acquirer" is the entity that obtains control of the acquiree. Appendix B of IFRS 3

provides further guidance on determining if the transaction constitutes the acquisition of a business and on identifying the acquirer.

For accounting purposes when there is a business combination, the acquirer is not always the entity which legally acquirers the other entity. Under a reverse acquisition, the entity whose stock is being legally acquired is the acquirer for accounting purposes, while the entity which is legally the acquirer becomes the acquired for accounting purposes. For example, a business combination can occur where a larger entity arranges to have itself bought by a smaller entity, perhaps due to a preference to utilise the common stock characteristics of the smaller entity. The actuary may want to consult with the principal's accounting experts to determine who the acquirer and acquired entities are for accounting purposes.

11.4. What if the transaction is not a business combination?

IFRS 3 excludes from its scope the acquisition of an asset or a group of assets that does not constitute a business. Paragraph 2(b) of IFRS 3 states:

> *"In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in IAS 38 Intangible Assets) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase."*

This guidance presents the possibility that the initial value of acquired assets or liabilities is different from its fair value.

11.5. How can the guidance in IFRS 3 for determining if a transaction is a business combination be applied to a transaction that involves contracts in the scope of IFRS 17?

One can conclude from IFRS 3 that the necessary conditions for defining a transaction involving insurance contracts as business combinations are:

- The portfolio or group of contracts must constitute a business or be part of a business; and
- Control over the portfolio is obtained as a result of the transaction.

Determination about whether a transaction is deemed to be a business combination is ultimately made by accounting professionals, but some considerations around what may or may not be a business combination are included here for reference:

The addition of individual or multiple contracts to an entity's book of business in a single transaction may not be sufficient to qualify as a business combination. The act of issuing contracts by itself is unlikely to be considered an acquisition or a business combination. For example, the issuance of several individual contracts to a single owner (e.g., as in the case of corporate-owned life insurance) or purchases of individual contracts in a secondary market (e.g., viatical settlements) would probably not be considered a business combination, but might be accounted for under ordinary insurance or reinsurance accounting rules. A business combination may include the right to issue

future contracts using the same distribution system associated with the purchased block. However, any values directly associated with such rights to issue contracts are not reflected in the liabilities or other values of acquired contracts but may be recognised as intangibles associated with the business combination, as discussed further below. Even without the transfer of the right to issue future contracts, the potential of the net cash flows associated with a portfolio of insurance contracts to generate profits may be sufficient for it to be deemed a business.

The transfer of a block of business from one entity to another might be considered a business combination if the acquirer obtains control of the associated contracts. An acquisition is distinct from a reinsurance transaction, other than novation or assumption reinsurance, as an acquisition transfers control over all aspects of contracts, whereas a reinsurer has at most limited control over the contracts reinsured. For example, an insurer might buy an individual line of business of a multi-line entity by buying certain assets, taking on its obligations through assumption reinsurance and taking control of the sellers' distribution system. The insurer in this example does not buy the shares of the seller, but nonetheless might be viewed as having acquired a business, and if so, would account for the transaction as a business combination.

11.6. What are the requirements of IFRS 17 for insurance contracts acquired in a business combination or in a transfer of contracts that do not form a business?

IFRS 17 provides guidance on the treatment of contracts acquired in a business combination or in a transfer of contracts that do not form a business combination. The distinction between a business combination and a transfer of contracts that does not constitute a business is discussed below. The application of the broader, non-insurance specific, guidance relating to business combinations and other acquisitions of assets or liabilities is discussed further in later sections of this chapter. The insurance-specific guidance in IFRS 17 relates to determining the initial Contractual Service Margin ("CSM") for acquired groups of contracts ("acquired group"). According to paragraphs B93-B95:

- The date of initial recognition of the acquired group is the date of the business combination or of the transfer, and the entity should treat those contracts as if they had been entered into on the date of the transaction.
- The initial consideration received or paid for the contracts acquired is a proxy for the premiums received or paid. The consideration excludes amounts paid for any other assets or liabilities acquired in the transaction. In most instances, the initial consideration for a business combination is the fair value of the contracts (see Chapter 10 – Fair Value).
- Unless the Premium Allocation Approach ("PAA") applies, the initial CSM for an acquired group is determined using the consideration as a proxy for the premium paid or received on the acquisition date. In a business combination, if the acquired group is onerous, the difference between the consideration for the acquired group and the fulfillment cash flows forms a loss component and is recognised as part of goodwill. If the transfer of contracts does not form a

business combination, the entity records a loss in the current period for the difference and establishes a loss component for the contracts.

The implication of these paragraphs is that the general requirements of IFRS 17 apply to insurance or reinsurance contracts acquired in a business combination or a transfer and that the fair value of the contracts is used in the determination of goodwill in a business combination. The effect of this implication is that the entity examines contracts acquired in a business combination or a transfer to determine which are in the scope of IFRS 17 and then applies the guidance in IFRS 17 on measurement, presentation, and disclosure to those contracts. There is not a presumption that a contract is insurance at the recognition date, even if it had been classified as insurance by the seller. For example, contracts that had been determined to be insurance contracts at the time that they originated, but, at an acquisition date after the initial application of IFRS 17 no longer transfer significant insurance risk would not be in the scope of IFRS 17 for the purposes of the acquirer. See also Chapter 1 – Classification of Contracts.

The presumptive unit of account for the transaction exists at the business combination level or the treaty (legal contract) level for a portfolio transfer. In practice, many actuaries will allocate the purchase price of the acquired contracts to a lower level of granularity for purposes of initial and subsequent measurement. The practice around unit of account will vary based on the facts and circumstances related to the transaction. (See Chapter 5 – Level of Aggregation for further information about unit of account.)

As noted, the consideration is used in determining the CSM for contracts that do not use the PAA. For contacts that use the PAA, the consideration represents the remaining unallocated premium of the relevant contracts as the liability for remaining coverage.

Liabilities for claims incurred on contracts issued by the acquired entity do not have a CSM. However, IFRS 17 is generally construed to mean that the acquisition of claims liabilities constitutes the issuance of a contract that transfers the risk of adverse development to the acquirer (paragraph B5). In some cases, the fair value and the fulfillment cash flows do not differ. In these cases, there is no CSM. In other cases, the fair value exceeds the fulfillment cash flows. This difference can be viewed as the part of the consideration that compensates the acquirer for the service provided. Hence, any positive difference between the fair value and the fulfillment cash flows of claims liabilities acquired in a business combination or in another transfer is deferred and released into income over the coverage period (i.e., the period over which the acquirer is obligated to settle the claims).

It is also possible that the fair value of acquired insurance contracts is less than the fulfillment value. This situation might occur, for example, if the market conditions were such that the market participants required a margin for risk and profit that was less that the entity's adjustment for risk. It might also be caused by the fact that a fair value considers the credit-standing of the entity, whereas the fulfilment value does not. In this situation, the acquired contracts are onerous; and if the contracts are acquired as part of a business combination, there is a loss component, but there is no effect on profit and loss because the amount by which the fulfillment value exceeds the fair value is

considered in goodwill. If the acquisition of the contracts is not part of a business combination, the entity recognizes a loss for the difference and establishes a loss component, as it would for contracts it issues.

The guidance in IFRS 17 for acquired insurance and reinsurance contracts is consistent with the general guidance in IFRSs for business combinations. Most of the relevant guidance for business combinations is found in IFRS 3. Additional relevant guidance is in IFRS 13 *Fair Value Measurement* ("IFRS 13"), in IAS 12 *Income Taxes* ("IAS 12"), and in IAS 38 *Intangible Assets* ("IAS 38"). Some of the guidance in these IFRSs, which may affect accounting for business combination or transfers, is discussed throughout this chapter.

11.7. What are the transition rules applying to business combinations or portfolio transfers that occur(ed) before the effective date of IFRS 17

The general guidance in IFRS 17 for transition applies to contracts in the scope of IFRS 17 acquired in a business combination or other transfer. As discussed previously, the recognition date of the acquired contracts is the date of the business combination or of the transfer. Hence, the transition does not require the entity to go back to the origination of the contracts but rather to the date the entity acquired them.

For acquisitions occurring before the initial application date of IFRS 17, the classification of contracts as insurance or otherwise is per the existing provisions of paragraph 17 of IFRS 3. Thus, contracts classified as insurance at origination would remain classified as insurance on acquisition if they were acquired before the application date of IFRS 17. There is no need to restate any existing goodwill balances or reassess whether the contract was in scope of IFRS 17 when it was acquired, even if IFRS 17 is applied retrospectively.

At transition, the date of initial recognition is the date of acquisition and the fair value of the group at that date would be required to apply the full or modified retrospective approach. If the fair value of the group at the date of acquisition is not available without hindsight, the fair value approach to transition would be used. Also, as clarified in IFRS 17 paragraphs C9A and C22A, incurred claims liabilities on groups acquired before the effective date of IFRS 17 can remain incurred claims liabilities. Thus, there is no need to go back to the date of acquisition and consider whether, under IFRS 17, they would have been changed to groups that transfer the risk of adverse development of claims costs.

Appendix to Chapter 11

This Appendix provides further information about IFRS 3, and is taken from IAN 11 – Business Combinations under International Financial Reporting Standards IFRS [2008], updated as of March 28, 2014.

What is the guidance in IFRS 3 for recognizing and measuring identifiable assets acquired and liabilities assumed in a business combination?

IFRS 3 requires the identifiable assets acquired and liabilities assumed in a business combination to be measured at fair value at the acquisition date (paragraphs 10 and 18 of IFRS 3). There is an emphasis on recognizing all identifiable assets acquired and liabilities assumed, reflecting the IASB's desire for entities to fully consider the difference between identifiable intangible assets and goodwill. The treatment of goodwill, which is described further in this appendix, is different from the treatment of intangible assets with definite lives and the allocation of the purchase price among these items affects the emergence of future profits.

To qualify for recognition, identifiable assets and liabilities acquired must:

- Meet the definition of assets or liabilities (paragraph 11 of IFRS3); and
- Be part of what the acquirer and the acquiree exchanged in the business combination rather than the result of a separate transaction (paragraph 12 of IFRS 3). Examples of separate transactions that do not constitute part of the business combination include settlement of pre-existing relationship between the acquirer and acquiree and remuneration to employees or former owners of the acquiree for future services.

Applying the recognition principles may result in recognition of assets or liabilities that the seller had not recognised in its financial statements. The application of the recognition and measurement concepts in IFRS 3 for intangible assets and other acquired liabilities is discussed below. The recognition and measurement of tangible invested assets, such as assets arising from ceded reinsurance invested assets, is not in the scope of this IAN. It is worth noting that there are some exceptions to the use of fair value measurement; for example, liabilities from retirement benefit plans are measured according to IFRS guidance for pension liabilities.

What are some examples of intangible assets arising from a business combination involving contracts in the scope of IFRS 17, and what are the accounting requirements?

Several potential intangible assets could arise from a business combination involving contracts issued by insurers. These include, but are not limited to:

i. Renewal rights for existing short-duration contracts;

ii. Distribution systems or relationships;

iii. Customer relationships for long duration contracts;

iv. Service agreements;

v. Brand names, trademarks, and copyrights;

vi. Proprietary software or technology;

vii. Licenses to transact insurance business;

viii. Product approvals and registrations; and

ix. Value of liability guarantee.

The paragraphs below provide descriptions of some of the more common intangible assets identified in combinations of insurance entities and some related considerations.

The first step, as already noted, is to determine if the intangible asset can be recognized. If so, the entity determines the asset's fair value, whether it has a finite or indefinite useful life, and the appropriate technique for the amortization of the asset (for those with finite lives and subject to amortization). Full development of common valuation and amortisation methods is beyond the scope of this IAN. While specific possible amortisation approaches are described for these assets, it should be kept in mind that IAS 38 provides that the amortisation period used should reflect the pattern in which an asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method could be used. There is also the possibility that some intangible assets have indefinite lives, and hence the intangible asset would not be amortised but rather tested for recoverability, which is referred to as testing for impairment. The actuary typically works with accountants and other professionals, such as valuation experts, to assist in determining which other potential intangible assets should be recognised and how they should be measured, amortised, and tested for impairment.

Value of renewal rights for existing short-duration contracts (also referred to as "customer lists" for short-duration contracts)

A common situation in non-life and group life insurance is the establishment of an intangible asset related to the value of renewal rights of existing short-duration contracts. The fair value may be based on market pricing benchmarks if such transactions and related benchmarks are reasonably well established for the market in which the acquired business resides. In some markets, benchmarks are based on a percentage of the premiums in-force or a percentage of annual premium writings. Absent benchmarks, the fair value might be based on the expected future distributable earnings from renewal contracts, usually net of the cost of capital discounted at a market discount rate commensurate with the risk of the cash flows. Among the methods for amortisation that have been used are:

- In relation to expected distributable earnings used to derive the fair value estimate; and
- Based on expected premiums from future renewals.

Value of distribution systems/relationships

The value associated with a distribution system may be significant, especially for distribution arrangements involving contingent commissions, business processing, and purchases of third-party intermediaries. Fair values of such systems might be derivable from cash flow models and from valuation specialists. Two of the possible amortisation methods that have been used for future business are 1) in relation to expected distributable earnings and 2) proportional to new business premiums.

Customer relationships and customer list – long duration contracts

Selling unrelated contracts to existing customers may provide the basis for an intangible asset, or it may be included in goodwill depending on the facts and circumstances. Care should be taken not to double count the value the asset related to a customer relationship and the value of a distribution system, if the considerations relate to the same future contracts and cash flows.

Service agreements

When a seller has entered into third-party contracts for certain services like claims administration, the acquirer considers whether an intangible asset might exist. There may be an intangible asset for the service component of investment or insurance contracts when this component is separated for recognition and measurement. Due consideration is given to whether the terms of such agreements are at, below, or above current market rates. The intangible asset, if any, may relate to the amount in fees that represent an above-market margin.

Amortisation methods historically used for such intangibles include:

i. In relation to the net revenue (i.e., fees charged less costs to provide the service) earned for providing the service; and

ii. ii. On a straight-line basis over the contract period.

Brand names, trademarks, copyrights

The entity being acquired may have a legal right to certain items (such as identifying names, slogans, and logos) that would qualify for separate recognition as intangible assets. Identifying the additional cash flows associated with such items may prove difficult. Amortisation might be based on the projected cash flows used to estimate the fair value. However, some legal rights may be renewable indefinitely or owned outright leading to the conclusion that the intangible should not be amortised.

Proprietary software or technology

Some insurers have developed expert systems that can be separately recognised as having value. Such systems can include underwriting, distribution/cross selling, and investment management. Amortisation of these systems-related intangible assets might be a straight line over an assumed lifetime of the system.

Licenses to transact insurance business

Paragraph 88 of IAS 38 requires entities to assess whether intangible assets have either a finite useful life or indefinite useful life. Licenses might be viewed as having an indefinite useful life such that their value is not amortised over time, although they may be subject to an impairment test. Their value might be derivable from market transactions for shell entities or from brokers in that market.

Product approvals or registrations

Product forms that have been approved for issue in certain jurisdictions can be determined to be intangible assets. The value could be viewed as the alternative cost to develop the same product and go through the approval process. Alternatively, the value could be viewed as something more if the product is in a niche market with limited access. Amortisation of the value could be based on the anticipated revenues expected from the sales of the new product.

How does the entity account for goodwill or for a gain from a bargain purchase?

IFRS 3 requires recognition of goodwill as of the acquisition date. Goodwill is the excess of the consideration transferred over the net of the identifiable assets and liabilities acquired. Identifiable assets here include those intangible assets that have been recognized in connection with the acquisition. Goodwill implicitly includes intangible assets that do not satisfy the criteria for recognition (paragraph 32 of IFRS 3).

Consideration may include not only cash but also equities, future consideration, and other types of compensation, and thus the determination of the value of consideration can become complex. IFRS 3 provides some guidance on determining the value of consideration transferred. Of particular note is the fact that transaction costs (such as legal, advisory, or accounting fees associated with the transaction) are not part of the consideration, per paragraph 53 of IFRS 3.

Goodwill represents a payment made by the acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised. The value of goodwill need not be justified but is subject to tests of impairment. Goodwill is not amortised under IFRS. Goodwill is to be measured subsequently at the amount recognised at the acquisition date less any accumulated impairment losses. The goodwill carrying amount is required to be tested for impairment in accordance with the requirements of IAS 36 Impairment of Assets (paragraph B63 of IFRS 3).

The excess of the consideration transferred over the net of the identifiable assets and liabilities acquired may be negative. In this case, the acquirer reassesses the fair value of acquired assets and liabilities to be sure that all acquired assets and assumed liabilities have been identified, recognised, and measured properly. If, after making adjustments for the reassessment, the excess remains negative, a bargain purchase is said to have occurred, and there is no goodwill. The gain on the business combination is recognised in the acquirer's profit and loss in the period in which the acquisition takes place (paragraphs 34-36 of IFRS 3).

Can there be a deferred tax asset or liability as a result of a business combination or other transfer?

The guidance for deferred taxes is found in IAS 12. The fair value of acquired assets and liabilities assumed in a business transaction may be different from the tax value of the respective assets or liabilities. Temporary differences arise from the business combination when the tax bases of the identifiable assets acquired and liabilities assumed are not affected by the business combination or are affected differently. For example, the initial value of insurance contracts acquired in a business combination is fair value, but the tax basis of the contracts may remain at the basis that it had to the seller. This difference is generally a taxable

temporary difference that gives rise to a deferred tax asset or liability (paragraph 19 of IAS 12). The deferred tax asset or liability is the amount of the difference multiplied by the tax rate that is expected to apply when the difference reverses. Hence, the calculation may require a projection of the reversal of the difference if it is necessary to reflect varying tax rates. There is no discounting in the calculation of a deferred tax asset or liability.

The resulting deferred tax asset or liability affects goodwill (paragraph 66 of IAS 12). When a deferred tax asset or liability is recognized as a result of a difference between the fair value of an item and its tax value in a business combination, this difference is considered in the determination of the goodwill or the amount of the bargain purchase gain.

The recognition of a deferred tax asset depends on the entity being able to assert that the asset is recoverable. A deferred tax asset is generally recognised for deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized. The carrying amount of a deferred tax asset is reviewed at the end of each reporting period. The entity reduces the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilized. Any such reduction can be reversed to the extent that it subsequently becomes probable that sufficient taxable profit will be available for the asset to be utilised (paragraph 27 of IAS 12).

What are the disclosure requirements related to business combinations?

Disclosure guidance for business combinations is found in paragraphs B64-B67 of IFRS 3. The disclosures include both qualitative and quantitative notes that "enable users of [the entity's] financial statements to evaluate the nature and financial effects of the business combination". The disclosures do not supplant disclosures required by IFRS 17. It may be necessary to make some of the disclosures for the acquired business separately. Although not explicitly stated in IFRS 17 or in IFRS 3, these disclosures may apply to transfers as well.

Chapter 12 – Transition

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

12.A. What does this chapter address?

This chapter considers the one-time event of presenting statements applying IFRS 17 for the first time. The chapter has four sections: an overview and then a section for each of the three transition approaches described in IFRS 17 – the retrospective approach of IAS 8 and the alternative approaches introduced by IFRS 17, modified retrospective and fair value. The chapter includes a sample timeline. This chapter also references content from Chapter 10 – Fair Value.

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

Paragraphs 114-116 and Appendix C of IFRS 17 provide guidance on this topic.

Paragraphs BC372-BC407 also provide background on the subject.

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

None

Overview

12.1. Where does the IASB describe the requirements for transition of the in-force insurance contracts or liabilities from current accounting standards to IFRS 17?

The effective date, requirements, and approaches are described in Appendix C of IFRS 17.

The transition requirements apply when an entity first applies IFRS 17.

12.2. What is the effective date of IFRS 17?

IFRS 17 applies to annual reporting periods beginning on or after 1 January 2023, with early application permitted. The start of the annual reporting period in which an entity first applies IFRS 17 is called the "*date of initial application*". Some jurisdictions may adopt other effective dates and may limit early adoption.

12.3. What IFRS 17 comparative information is required?

There is a requirement to provide IFRS 17 financial statements as of the beginning of the period immediately preceding the date of initial application (comparatives).

The dates that follow apply for entities with quarterly financial reporting and an assumed date of initial application of 1 January 2023. Analogous dates would apply in other situations. On 31 March 2023, the entity will report the following on the new IFRS 17 basis:

- the 31 December 2021 (1 January 2022) opening balance information needed to prepare the comparative information;

- The statement(s) of financial performance for the 3-month period ending 31 March 2022;
- The 31 March 2022 statement of financial position will not be presented but will be necessary to the extent needed to prepare the 31 March 2022 statement(s) of financial performance;
- The 31 December 2022 statement of financial position;
- The statement(s) of financial performance for the 3-month period ending 31 March 2023; and
- The 31 March 2023 statement of financial position.

Further, on 31 March 2023, the entity will provide the disclosures required in paragraphs 93-132.

12.4. Can more than one year of IFRS 17 comparative information be presented?

Yes, an entity is permitted to present more than one year of IFRS 17 comparative information (paragraphs C25-C28). The beginning of the earliest adjusted comparative period presented (which would be the beginning of the period immediately preceding the date of initial application when only one year of comparative information is presented) is called the "transition date". In the example shown in question 12.3, the transition date would be January 1, 2022. If an entity chooses to present two years of comparative information (both of which are based on IFRS 17), the transition date would be January 1, 2021. See paragraphs C2 and C25.

12.5. If provided, how is comparative information for earlier periods presented?

If the comparative information and disclosures for earlier periods are adjusted by applying IFRS 17, question 12.3 applies, except the disclosures in paragraphs 93-132 are not required. If the comparative information and disclosures for earlier periods are unadjusted, paragraph C27 requires the entity to "*clearly identify the information that has not been adjusted, disclose that it has been prepared on a different basis, and explain that basis.*"

12.6. If the implementation of IFRS 9 is deferred until the implementation of IFRS 17, what is the interaction with the IFRS 17 comparative financial statements?

IFRS 9 does not require comparative financial statements and does not allow comparatives that require hindsight to be presented. However, the implementation of IFRS 9 (e.g., the designation of assets) might be different under IFRS 17 than under the current financial reporting standards. If so, the IFRS 17 comparative financial statements would be more meaningful if asset values under IFRS 9 were also restated. The entity would therefore be prepared to present IFRS 9 comparatives without the use of hindsight. Assuming the above timeline with one year of comparatives, the re-designation of assets under IFRS 9 would be as of 31 December 2021.

12.7. If IFRS 9 is implemented before IFRS 17, are financial assets re-designated when IFRS 17 is implemented?

The guidance for re-designation and related disclosures is in paragraphs C29-C33. If there are assets designated as fair value through profit or loss to avoid an accounting mismatch, that designation must be revoked if the accounting mismatch no longer exists under IFRS 17. Otherwise, re-designation of assets is permitted but not required.

As described in question 12.6, the IFRS 17 comparative financial statements would be more meaningful if presented with the implementation of IFRS 9 that will be adopted with IFRS 17.

12.8. What time period does the transition guidance cover?

The transition guidance applies to all insurance contracts or liabilities in force at the transition date, which is 31 December 2021 in the preceding timeline. All insurance contracts issued after that date would be subject to IFRS 17.

12.9. In addition to IFRS 17, what other guidance applies to transition?

Implementing IFRS 17 is considered a change in accounting policy, so IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* applies, except, per paragraph C3, the entity need not disclose the quantitative information required by paragraph 28(f) of IAS 8.

12.10. What is the impact on previous business combination balances of paragraph C4(b) of IFRS 17?

Paragraph C4(b) requires the entity to derecognise all balances that would not have existed had IFRS 17 always applied. This would include balances arising from business combinations that would not have existed had the business combination taken place under IFRS 17. For example, value of business acquired (VOBA) balances will be derecognised, but goodwill balances will be unchanged at the transition date.

See question 12.23 for the treatment of incurred claims acquired in a transfer or business combination.

12.11. What is to be measured or determined at transition?

At the transition date, the following is required for each group of insurance contracts ("group"):

- the carrying value of the liability (or asset) for remaining coverage, with separate measurement of the present value of future cash flows, risk adjustment for non-financial risk, and, where applicable, the CSM or loss component;
- the liability for incurred claims, with separate measurement of the present value of future cash flows and the risk adjustment for non-financial risk;
- the "locked-in discount rates", which are the discount rates used for CSM accretion and CSM adjustments;

- the accumulated other comprehensive income ("OCI"), if the OCI option is elected;
- the balance of unamortised insurance acquisition cash flows for groups recognised at the transition date (unless the fair value approach is used), and
- any asset for insurance acquisition cash flows incurred before the transition date but allocated to groups or contracts that are expected to be recognized after the transition date. The entity is not required to assess recoverability of these assets (paragraph C4(aa).

12.12. How should these items be measured or determined?

Appendix C describes three approaches for transition: full retrospective, modified retrospective, and fair value.

The measurement of fulfilment cash flows at the transition date is a straightforward application of paragraphs 33-37. However, the CSM or loss component, the locked-in discount rates, the accumulated OCI and the balance of unamortised insurance acquisition cash flows all require information from the date of initial recognition, which may be many years before the date of transition. These items are therefore the focus of the transition guidance.

12.13. How does the entity decide which approach to use for each group of contracts?

As set out in paragraph C5, the full retrospective approach must be used unless it is impracticable to do so, in which case the entity must choose between the modified retrospective approach and the fair value approach. However, if reasonable and supportable information necessary to apply the modified retrospective approach is not available, the fair value approach must be used.

For the remainder of this section, "*available information*" should be read as "*reasonable and supportable information that is available without undue cost or effort*".

Paragraph C5A allows an entity to apply the fair value approach for a group of contracts with direct participation feature if and only if the entity chooses to apply the risk mitigation option in paragraph B115 prospectively from the transition date and the entity has used derivatives, non-derivative financial instruments measured at fair value through profit or loss, or reinsurance held before the transition date.

12.14. How does an entity decide which approach to use for an asset for insurance acquisition cash flows?

As set out in paragraph C5B, the full retrospective approach must be used unless it is impracticable to do, in which case the entity must choose between the modified retrospective approach or the fair value approach.

12.15. How does the entity identify groups of contracts at transition?

Paragraphs 14-24 describe the criteria for identifying groups. Under the full retrospective approach, identification of groups requires the assessment of these criteria as at the date of initial recognition of the contracts in each group. If this information is not available or

cannot be reasonably estimated, the full retrospective approach would not be used. Identification of groups under the modified retrospective approach and the fair value approach are described in later questions of this chapter.

12.16. What other information is needed to use the full retrospective approach?

See questions 12.24 to 12.30. If any material information is not available or cannot be reasonably estimated, the full retrospective approach would not be used.

12.17. Would multiple approaches be used on a single group of contracts?

For a group, only one approach would be applied.

12.18. What does impracticable mean?

IAS 8 states:

"Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

(a) the effects of the retrospective application or retrospective restatement are not determinable;

(b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

(c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

I. provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and

II. would have been available when the financial statements for that prior period were authorised for issue from other information."

Effectively, this requires the entity to demonstrate that although it has made every reasonable effort to gather the necessary information to enable it to determine the required elements retrospectively, that information is not available, or not available in a form that would enable it to be used without undue cost and effort. Information might be unavailable for a variety of reasons including:

- the information is no longer in the entity's possession;
- the information is available but outside the entity's normal retention policy and so might not be complete;
- the entity has the information but is unusable because of technological constraints;
- the need to determine what decisions management might have taken in the past; and

- the information requires hindsight to understand management's intent or the entity's view.

Paragraph BC378 gives examples of items needed for retrospective application for which measurement would often be impracticable.

12.19. Are separate disclosures required for groups using different approaches?

Yes. Paragraphs 114-116 describe the required disclosures.

12.20. For measurement at a date subsequent to the transition date, can new contracts be added to the groups established at the transition date?

For groups measured at transition using the full retrospective approach, new contracts can be added to the groups established at transition if consistent with paragraphs 14-24D (e.g., if the group established at transition only covers 6 months of issues the group could continue until the full year maximum is reached).

For groups measured at transition using the modified retrospective approach or the fair value approach, the disclosure requirements of paragraphs 114-116 may prohibit new contracts being added to such groups.

12.21. What transition requirements are different for groups of insurance contracts with (vs. without) direct participation features?

The locked-in discount rates are not needed.

12.22. What transition requirements are different for groups of contracts measured using the premium allocation approach?

For the liability for remaining coverage, there is no risk adjustment or CSM or loss component to be determined at transition. Also, the locked-in discount rates are needed only if the group has a significant financing component and the liability for remaining coverage reflects the time value of money and financial risk (paragraph 56).

12.23. What transition requirements are different for liabilities for incurred claims?

There is no CSM or loss component for liabilities for incurred claims. The locked-in discount rates are not needed for CSM accretion or future CSM adjustments and so is only required if the OCI option is elected.

For groups using the premium allocation approach, the locked-in discount rates for the liability for incurred claims are based on the incurred date rather than the date of initial recognition of the group.

A liability for incurred claims shall be classified for claims settlement incurred before acquisition of transferred contracts. Any post-transition contracts are measured as a liability for remaining coverage.

The Full Retrospective Approach

12.24. Are simplifications and approximations permitted when applying the full retrospective approach?

The full retrospective approach involves looking back to the date of initial recognition and determining the liability (including the CSM or loss component) on that date as if IFRS 17 had been in effect. Then, to determine the CSM or loss component at the transition date, the CSM or loss component at the date of initial recognition would be adjusted through time as described in paragraphs 43-45 (CSM) and 50-52 (loss component) taking into account all contracts that were in-force at each reporting date between the date of initial recognition and the transition date.

Simplifications and approximations are permitted, if they do not have a material impact on the results. If any material information is not available and cannot be reasonable estimated, the full retrospective approach would not be used.

12.25. How are groups of contracts identified?

Paragraphs 14-24 describe the criteria for identifying groups. Under the full retrospective approach, identification of groups requires the assessment of these criteria as at the date of initial recognition of the contracts in each group.

12.26. How are the locked-in discount rates determined?

The locked-in discount rates are the discount rates that would have been established at the date of initial recognition as described in paragraph 36. For contracts with cash flows that vary based on the returns on any underlying items, the discount rates that would have applied to nominal cash flows that do not vary based on the returns on any underlying items are also required (paragraph B72(b)).

12.27. How is the liability (and in particular, the CSM or loss component) determined at the date of initial recognition?

Actual policy data for all contracts originally in the group would be used to estimate future cash flows. Information (e.g., assumptions and acquisition cash flows) required to estimate future cash flows, the risk adjustment, and the CSM or loss component would use only the information that would have been available at the date of initial recognition, without the use of hindsight.

In particular, the risk adjustment at the date of initial recognition would reflect the assessment of risk and the view of compensation required from the perspective of the entity as at the date of initial recognition. As noted in question 12.26, the discount rates would be the discount rates that would have been established at the date of initial recognition as described in paragraph 36.

12.28. How is the CSM or loss component measured at the transition date?

The CSM or loss component at the transition date would be measured by taking the CSM or loss component at the date of initial recognition (determined as in question 12.27) and

adjusting through time as described in paragraphs 43-45 (CSM) and 50-52 (loss component) of IFRS 17.

Note that all contracts that were in the group at the date of initial recognition would contribute to the determination of the liability at the date of initial recognition. Furthermore, cash flows and coverage units associated with these contracts would contribute to the adjusting through time of the CSM or loss component.

All adjustments (including amortisation) made to the CSM or loss component would use only the information that would have been available at the date each adjustment would have been made, without the use of hindsight. However, per paragraph C3(b), for groups of contracts with direct participation features, the option described in paragraph B115 would not be applied prior to the transition date. An entity may apply the option in paragraph B115 prospectively after the transition date if, and only if, the entity designates risk mitigation relationships at or before the date it applies the option.

The adjustments to the CSM or loss component would be made as at each reporting date between the date of initial application and the transition date. If the resulting CSM or loss component would be materially similar, adjustments could be made less frequently (e.g., annually).

12.29. If the OCI option is elected, how is the accumulated OCI at the transition date measured?

For groups for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder, the accumulated OCI at transition is the difference between the fulfilment cash flows measured using the locked-in discount rates and the fulfilment cash flows measured using the discount rates in effect at the transition date.

For groups for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholder but which are not insurance contracts with direct participating features where the entity holds the underlying items (i.e., when paragraph 88 applies), the systematic allocation that would have been adopted at the date of initial recognition (per paragraph B132) would be determined and applied retrospectively to measure the accumulated OCI at transition.

For groups with direct participation features where the entity holds the underlying items (i.e., when paragraph 89 applies), the accumulated OCI at transition would be measured retrospectively applying paragraphs B134-B136 and would be equal but opposite to the OCI of the underlying items (see paragraph C18(b)(ii))

For groups of contracts applying the premium allocation approach, the accumulated OCI at transition for the liability for incurred claims is the difference between the fulfilment cash flows measured using the discount rates in effect at the date the claim was incurred and the fulfilment cash flows measured using the discount rates in effect at the transition date.

12.30. How is the balance of unamortised insurance acquisition cash flows determined?

The balance of unamortised insurance acquisition cash flows would be determined by taking the insurance acquisition cash flows allocated to the group for the purpose of calculating the CSM or loss component at the date of initial recognition and removing the portion that would have been amortised under paragraph B125.

The Modified Retrospective Approach

12.31. When can the modified retrospective approach be used?

When it is impracticable to apply the full retrospective approach to a group of contracts, the entity must choose to use either the modified retrospective approach or the fair value approach. However, the entity may only choose the modified retrospective approach if it can obtain reasonable and supportable information necessary to do so. If not, as per the requirements of IFRS17, the fair value approach shall be used.

12.32. What is the modified retrospective approach trying to achieve?

The objective of the modified retrospective approach is to achieve the closest outcome to the full retrospective approach possible.

12.33. How does the entity achieve this objective?

The entity would maximise the use of information that would have been used to apply the full retrospective approach.

Appendix C describes specific modifications, each of which is permitted only to the extent that the entity does not have reasonable and supportable information to apply the full retrospective approach (per paragraph C8). The assessment of which modifications are permitted would be made for each modification for each group. No other modifications are permitted.

12.34. How are groups of contracts identified under the modified retrospective approach?

If the information is available, groups would be identified applying paragraphs 14-24.

Paragraph 14 requires the identification of portfolios of insurance contracts ("portfolio"), where a portfolio comprises contracts that are subject to similar risks and managed together. To the extent information is not available, one of the permitted modifications of the modified retrospective approach allows the entity to identify portfolios based on how its business is managed at transition.

Furthermore, at the time of transition, information from the date of initial recognition about whether contracts would have met the definition of insurance contracts with direct participation features when they were issued may not be available. In this case, one of the permitted modifications of the modified retrospective approach allows the entity to use information available at transition to determine whether a contract meets the definition of an insurance contract with direct participation features.

Paragraphs 15-21 indicate that portfolios are split into three (or more if desired) groups based on the profitability of contracts at initial recognition. At the time of transition,

information from the date of initial recognition about the profitability of contracts issued in past years may not be available. In this case, one of the permitted modifications of the modified retrospective approach allows the entity to use information available at transition to assess the profitability of contracts for the purpose of grouping. That is, information about the profitability of contracts currently being issued can be applied to similar contracts issued in past years. However, such information must be reasonable and supportable, otherwise the fair value approach would be used. The longer it has been since the policy has been issued may be a consideration in determining if the information at transition is reasonable and supportable.

Paragraph 22 requires the groups determined per paragraphs 14-21 to be further divided so that contracts issued more than one year apart are not included in the same group. Paragraph C10 permits a modification of this requirement when information is not available.

12.35. How are the locked-in discount rates determined under the modified retrospective approach?

If contracts issued more than one year apart are included in the same group (i.e., the modification in paragraph C10 is made), the entity is permitted (paragraph C18(a)), to determine the locked-in discount rates using the discount rates in effect at the date of transition rather than the discount rates in effect at the date of initial recognition.

Otherwise, if available, the locked-in discount rates are the discount rates that would have been established at the date of initial recognition as described in paragraph 36.

If not available, one of the permitted modifications of the modified retrospective approach allows the entity to use the relationship between an observable yield curve and the current discount rates to estimate the discount rates as at the date of initial recognition as follows:

- If there is an observable yield curve that approximates the current discount rates for at least three years before the transition date, that observable yield curve at the date of initial recognition would be used to determine the locked-in discount rates.
- If such an observable yield curve does not exist, but there is an observable yield curve with a reasonably consistent spread to the current discount rates, the average spread between that observable yield curve and the current discount rates would be applied to that observable yield curve at the date of initial recognition to determine the locked-in discount rates. The average spread shall be an average over at least three years before the transition date (paragraph C13(b)).

12.36. How is the CSM or loss component at the transition date measured under the modified retrospective approach?

The full retrospective approach would be used to the extent information is available. The following modifications are permitted to the extent information is not available:

Insurance contracts without direct participation features

- **Discretionary cash flows** – The entity would use information at the transition date (rather than the date of initial recognition) to determine how to identify discretionary cash flows for the purpose of applying paragraphs B98–B100. That is, the entity would use policies on discretionary payments that apply at the date of transition if the policies on discretionary payments that applied at the time of initial recognition are not available.
- **Future cash flows** – The future cash flows at the date of initial recognition would be estimated as the future cash flows at the transition date (or an earlier date if the information is available) adjusted by the cash flows that are known to have occurred between the initial recognition and the transition date (or earlier date). Such known cash flows would include cash flows related to all contracts that would have been in the group at the date of initial recognition, including contracts that are no longer in force at the transition date.
- **Risk adjustment** – The risk adjustment at the date of initial recognition would be estimated as the risk adjustment at the transition date adjusted by the expected release of risk before that date. The expected release of risk would be based on the release of risk for similar contracts the entity is issuing at the transition date.
- **CSM amortisation** – The entity would estimate the amount of CSM recognised in profit or loss because of the transfer of services (paragraph 44(e)) between the date of initial recognition and the transition date by comparing the remaining coverage units (for contracts still in-force at the transition date) with the coverage units provided under the group of contracts before the transition date.
- **Loss component** – If there is a loss component at initial recognition, the entity would estimate the amount allocated to the loss component before the transition date using a systematic allocation consistent with the modifications adopted above.
- **Interim Financial Statements** – The entity shall determine the CSM or loss component at the transition date as if the entity had not prepared interim financial statements.
- **Acquisition Cash Flows** – The entity shall use the same systematic and rational method the entity expects to use after the transition date when applying paragraph 28A to any insurance acquisition cash flows paid before the transition date to (a) groups of contracts that are recognised at the transition date; and (b) groups of contracts which are expected to be recognised after the transition date. Insurance acquisition cash flows paid before the transition date that are allocated to a group recognised at the transition date adjust the CSM of that group. Other insurance acquisition cash flows paid before the transition date, including those allocated to a group of insurance contracts expected to be recognised after the transition date, are recognised as an asset applying paragraph 28B. If reasonable and supportable information is not available, the asset for insurance acquisition cash flows incurred

before the transition date but allocated to groups expected to be recognized after the transition date is set to nil (paragraph C14D).

- **Loss Recovery component** – A loss recovery component may be included under the modified approach if better information is not available.

Insurance contracts with direct participation features

The entity would measure the CSM at the transition date as the total fair value of the underlying items at the transition date minus:

- the fulfilment cash flows at the transition date, adjusted as described in paragraph C17(c); and
- (if CSM), minus the amount of CSM that relates to service provided before the transition date, estimated by comparing the remaining coverage units with the coverage units provided under the group of contracts before the transition;
- (if loss component), adjust the loss component to nil and increase the liability for remaining covering by the same amount.

If information is not available to apply a permitted modification, the fair value approach must be used.

12.37. When should a loss component for reinsurance held be determined?

For a group of reinsurance contracts held that provides coverage for an onerous group of insurance contracts and was entered into before or at the same time that the insurance contracts were issued, an entity shall establish a loss-recovery component of the asset for remaining coverage at the transition date. Per paragraph C16A, the loss-recovery component is determined by multiplying:

(a) the loss component of the liability for remaining coverage for the underlying insurance contracts at the transition date; and

(b) the percentage of claims for the underlying insurance group the entity expects to recover from the group of reinsurance contracts held.

In the absence of reasonable and supportable information to do the calculation, the entity shall not identify a loss-recovery component for the group of reinsurance contracts held.

12.38. If the OCI option is elected, how is the accumulated OCI at the transition date measured under the modified retrospective approach?

For contracts with direct participation features where the entity holds the underlying items (i.e., when paragraph B134 applies), the accumulated OCI at transition would be the accumulated OCI on the underlying items.

Otherwise, the accumulated OCI at transition would be:

- The difference between the fulfilment cash flows measured using the locked-in discount rates and the fulfilment cash flows measured using the discount rates in

effect at the date of transition for contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder; and

- Nil for contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholder.

Furthermore, if contracts issued more than one year apart are included in the same group (i.e., the modification in paragraph C10 is made), the entity is permitted to determine the accumulated OCI for contracts without direct participation features as nil.

Note that the accumulated OCI would be nil whenever (per the first paragraph of question 12.35) the entity chooses to determine the locked-in discount rates as the discount rates in effect at the date of transition.

12.39. How is the balance of unamortised insurance acquisition cash flows determined under the modified retrospective approach?

The modification related to future cash flows in question 12.36 can be used if the information required to determine the balance of unamortised insurance acquisition cash flows retrospectively is not available (see question 12.30).

The Fair Value Approach

12.40. What is the fair value used for?

The CSM or loss component at transition is determined as the fair value of a group at the transition date minus the fulfilment cash flows of the group as at the transition date.

12.41. How are groups identified under the fair value approach?

Per paragraphs C21-C22, the entity may choose to use the information available at transition rather than the information as at initial recognition to identify groups. This includes identifying portfolios.

Furthermore, per paragraph C23, the entity may choose not to apply paragraph 22 and thereby include contracts issued more than one year apart in a group.

Therefore, when applying the fair value approach at transition, the entity may identify portfolios based on how it manages the business at transition and determine that there are three groups per portfolio (onerous, no significant risk of becoming onerous, other), with no division of those groups by year of issue.

12.42. How are the locked-in discount rates determined under the fair value approach?

Per paragraph C23, the entity may choose to determine the locked-in discount rates as the discount rates in effect at the date of transition or the date of the initial recognition of the group.

12.43. How is the fair value of a group as at the transition date measured?

The fair value of a group is analogous to the consideration received/paid on portfolio transfer or business combination. It is the amount the entity would have to pay a third party to take on the obligations and risks of the group.

IFRS 13 Fair Value Measurement provides guidance on measuring fair value. See Chapter 10 for guidance on the application of IFRS 13 to insurance contracts on transition to IFRS 17.

The fair value at the date of transition would use observable market information, assumptions, economic information, views on the cost of risk, etc. as at the date of transition.

12.44. How are the fulfilment cash flows of the group as at the transition date measured?

The measurement of fulfilment cash flows at the transition date is described in paragraphs 33-37.

12.45. For a group of reinsurance held contracts measured at fair value, when should a loss-recovery component be calculated?

For a group of reinsurance contracts held, per paragraph C20A, an entity shall determine the loss-recovery component of the asset for remaining coverage at the transition date by multiplying:

a. the loss component of the liability for remaining coverage for the underlying insurance contracts at the transition date; and

b. the percentage of claims for the underlying insurance contracts the entity expects to recover from the group of reinsurance contracts held.

In the absence of reasonable and supportable information to do the calculation, the entity shall not identify a loss-recovery component for the group of reinsurance contracts held.

12.46. If the OCI option is elected, how is the accumulated OCI at the transition date measured under the fair value approach?

For contracts with direct participation features where the entity holds the underlying items (i.e., when paragraph B134 applies), the accumulated OCI at transition would be the accumulated OCI on the underlying items.

Otherwise, the entity can choose to set the accumulated OCI to nil or to measure the accumulated OCI retrospectively if the information is available.

12.47. Is balance of unamortised insurance acquisition cash flows required under the fair value approach?

The balance of unamortised acquisition expenses related to groups already recognised at the transition date is not required (per discussion at the February 2018 TRG paper AP06).

However, any asset for insurance acquisition cash flows incurred before the transition date but allocated to contracts or groups expected to be recognised after the transition date is required. See question 12.14.

Section D – Other IFRS 17 Topics

This section includes two chapters that cover do not logically fall within any of the other sections. These are:

- Embedded Derivatives – Chapter 13
- Contract Modifications and Derecognition - Chapter 14

Chapter 13 discusses the issues which may arise in detecting and identifying embedded derivatives in such contracts which may need to be separated. This Chapter only considers the requirements under IFRS 17 for the separation of certain derivatives embedded in contracts subject to the scope of IFRS 17. Further information about embedded derivatives based on other IFRSs is found in IAN 11 Embedded Derivatives

Chapter 14 discusses what is and is not considered to be a contract modification and how to account for them. The chapter also discusses the circumstances under which a contract is derecognised.

Chapter 13 – Embedded Derivatives

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

13.A. What does this chapter address?

This chapter considers the requirements under IFRS 17 for the separation of certain derivatives embedded in contracts subject to the scope of IFRS 17. This chapter discusses the issues that may arise in detecting and identifying embedded derivatives in contracts that may need to be separated. Further information about embedded derivatives based on other IFRSs is found in the existing IAN 10 – Embedded Derivatives and Derivatives under International Financial Reporting Standards IFRS [2007].

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

Paragraphs 11(a) and B10 provide guidance on this topic.

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

IAN 10 – Embedded Derivatives and Derivatives under International Financial Reporting Standards IFRS [2007].

13.1. What is a derivative and an embedded derivative?

Derivatives and embedded derivatives are defined in IFRS 9 in paragraph 4.3.1.

Paragraph 4.3.3 of IFRS 9 includes conditions for separating an embedded derivative, which are applicable according to paragraph 11(a) of IFRS 17 to insurance contracts and other contracts in the scope of IFRS 17. The guidance regarding definition of derivatives and embedded derivatives and the conditions for separation of those have not changed (other than changes for financial assets) from those in IAS 39 (albeit Appendix A to IAS 39 is not included in IFRS 9), and accordingly the contents of IAN 10 which refer to IAS 39, remain valid. This also applies to other aspects of accounting for embedded derivatives that are to be separated.

13.2. What are the IFRS 17 requirements on the accounting for embedded derivatives?

The requirements in IFRS 17 on the accounting for embedded derivatives are limited (see paragraph 11(a) as noted above). In particular, IFRS 17 states that IFRS 9 is applied to determine whether an embedded derivative is to be separated and, if so, how it is to be accounted for.

IFRS 9 defines a derivative as a "*financial instrument or other contract within the scope of*" IFRS 9 "*with all three of the following characteristics*:

a. Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. It is settled at a future date"

Paragraph 4.3.3 of IFRS 9 sets out the conditions that all need to be met for separating an embedded derivative where the host contract is not within the scope of IFRS 9 (as in the case of host insurance contracts within the scope of IFRS 17):

- Paragraph 4.3.3(a) requires that the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host. This is further expanded in Paragraphs B4.3.5 and B4.3.8 of IFRS 9, in particular, B4.3.8(h) states: "A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (i.e., without considering the host contract)."
- Paragraph 4.3.3(b) requires that the separated component should meet the definition of a derivative on a standalone basis. This requirement might be seen as not met if the embedded derivative would be considered standalone under IFRS 17. This would be the case where the separate derivative still includes significant insurance risk transfer (see paragraph B10 of IFRS 17) and where the embedded derivative is a financial guarantee contract that is considered to fall within the scope of IFRS 17 (see paragraph 2.1(e) of IFRS 9).
- Paragraph 4.3.3(c) requires that the entire contract (i.e., host and embedded derivative) is not measured at fair value through profit or loss. This requirement might be seen to be met generally by contracts in the scope of IFRS 17, as the condition might be seen to refer explicitly to the measurement of the entire contract on an IFRS 17 basis that differs from fair value through profit or loss.

Paragraph B4.3.1 of IFRS 9 notes that paragraph 4.3.3 of IFRS 9

"requires the entity to identify any embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently at fair value through profit or loss."

In addition, paragraph 4.3.5 of IFRS 9 states:

"Despite paragraphs 4.3.3 and 4.3.4, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this Standard, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

(a) the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or

(b) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option

embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost."

Embedded derivatives that are not required to be separated (under IFRS 9) are considered as part of the insurance contract and accounted for under IFRS 17.

13.3. Are the IFRS 17 requirements on embedded derivatives different from those in IFRS 4?

The requirements may be different.

Paragraph 8 of IFRS 4 stated that, as

"an exception to the requirements in IFRS 9, an insurer need not separate, and measure at fair value a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differs from the carrying amount of the host insurance liability."

This exception is not included in IFRS 17. This might be seen as a requirement to separate embedded derivatives of that kind, if they meet the conditions in paragraph 4.3.3. of IFRS 9.

In addition, the IFRS 4 implementation guidance (IG3 and 4) provided 20 examples of products, some with and some without embedded derivatives requiring separation. The IFRS 4 implementation guidance has not been included in the implementation guidance to IFRS 17. As a consequence, there may be a difference in the scope of embedded derivatives requiring separation. This might require an assessment based on the nature of individual contract types.

Experience of applying IFRS 4 showed that, in many countries, the majority of insurance products do not contain embedded derivatives that require separation. It is unclear yet whether the mentioned changes might have a different result.

13.4. Are there specific disclosure requirements for embedded derivatives?

For embedded derivatives that are not separated and so are part of an insurance contract, there are no additional specific disclosure requirements in IFRS 17. For reference in IFRS 4, paragraph 39(e) specifically required that information about the exposure to market risk be disclosed if such embedded derivatives are not measured and presented at fair value through profit or loss.

For embedded derivatives that are separated, the disclosure requirements are as set out in IFRS 9.

Chapter 14 – Contract Modifications and Derecognition

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

14.A. What does this chapter address?

This chapter considers the treatment under IFRS 17 of contract modification to insurance contracts, including reinsurance contracts, and de-recognition, including transfer to third parties.

This chapter discusses what is a contract modification and which of these:

- result in the derecognition of the original contract and recognition of the modified contract as a new contract; or
- can simply be treated as a change in estimates.

The chapter also describes:

- a possible approach for determining the premium when the modification is treated as a cancellation and replacement of the original contract; and
- application under the premium allocation approach (PAA).

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

Paragraphs 72–77 provide guidance on this topic.

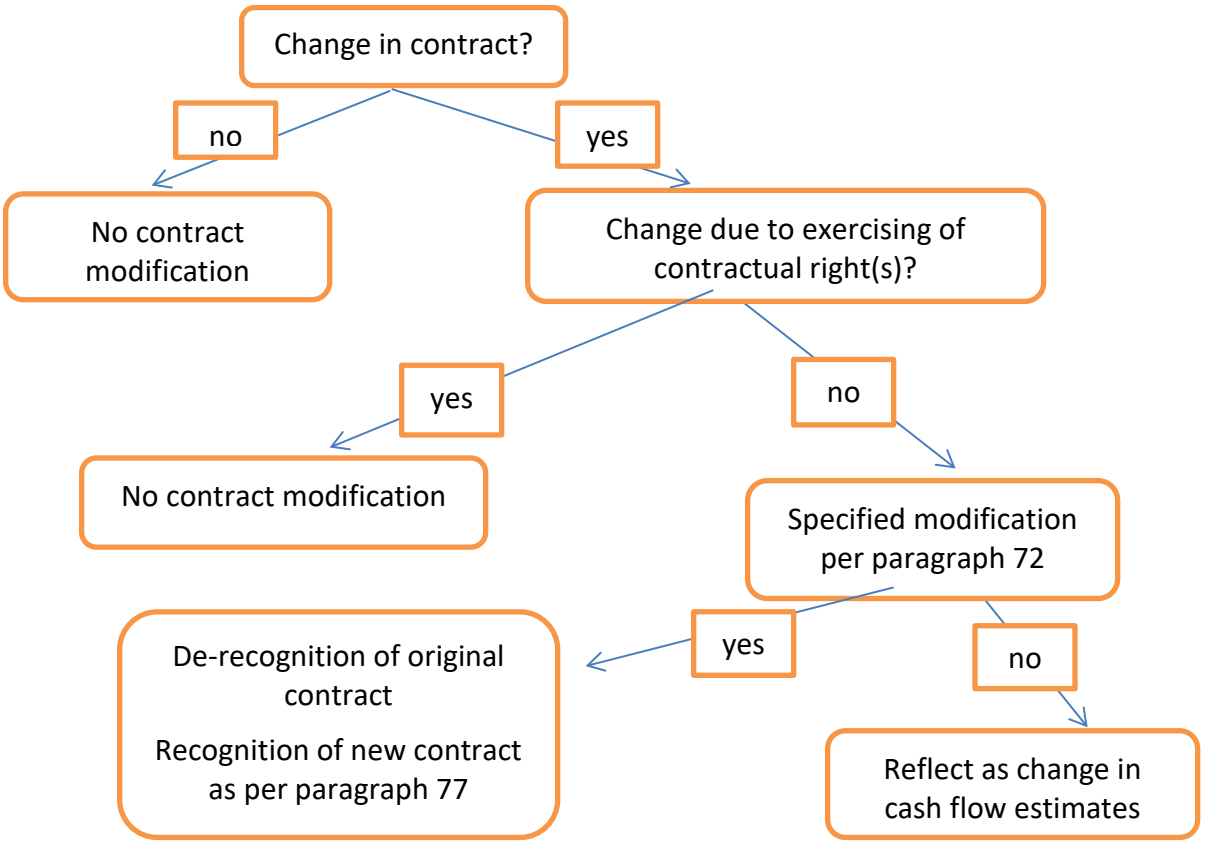
Paragraphs BC306 and BC316–322 also provide background on the subject.

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

None

Overview

The following flowchart is included to help in understanding whether or not there is a contract modification which needs to be accounted for. The flowchart is designed to be used in conjunction with the questions in this chapter.



What is a contract modification?

14.1. What is a contract?

See Chapter 1 – Classification of Contracts.

14.2. How does IFRS 17 define a contract modification?

Paragraph 72 provides examples of contract modifications, which are changes to the legally enforceable terms of the contract, including "agreement between the parties to the contract or by change in law or regulation". The exercise of any rights or options available under the contract, by one or both parties, are not contract modifications and form part of the expected cash flows of the original contract (see paragraph 72).

14.3. What is a contract modification?

The following provides a non-exhaustive list of examples of what are and are not contract modifications for IFRS 17 purposes.

(a) The following generally require the agreement of both insurer and policyholder to take effect and, if this is the case, then they are a contract modification. However, if they arise from an option available to either the insurer or policyholder under the contract, then they are enforceable without the agreement of the other party and form part of the terms of the contract at issue. Note, any requirement to notify the other party in order to exercise the option, does not of itself imply their agreement is required.

(i) an increase or decrease in the nature or level of benefits under the contract, which could include changes to extend or reduce the period of cover under the contract (i.e., affect the contract boundary), unless they arise from the exercise of an underwritten option under the contract (see question 14.4), or they only affect coverage beyond the contract boundary (see Chapter 1 – Classification of Contracts);

(ii) the addition or removal of benefits under the contract;

(iii) the addition or removal of coverages under the contract;

(iv) the addition or removal of options or guarantees available under the contract;

(v) any change to premiums;

(vi) any change of insurance (including reinsurance) contracts terms and conditions requiring the consent of both parties; and

(vii) a change to contractual terms arising from change in regulation;

(b) The following are considered not to be a contract modification:

(i) the exercise of any options available to the policyholder under the terms of the contract (or law) within the contract boundary that do not require the agreement of the insurer. This does not include any requirement to notify the other party in order to exercise. Examples include:

- an option to renew the contract under the terms of the contract without further underwriting;
- an option to surrender the contract or to cease paying premiums while still receiving benefits under the contract;
- the exercise of a contractual right to suspend and later resume cover under the contract without a new risk assessment;
- an option to increase cover on renewal (e.g., with consumer price index) or at other times under the contract (e.g., guaranteed future insurance options) without further underwriting; and

- contracts arising from guaranteed insurability options, as these form part of the original contract terms and are neither a new contract nor a contract modification (e.g., guaranteed annuitisation option under a deferred annuity contract).

(ii) the exercise of any options available to the insurer under the terms of the contract (or law) within the contract boundary that do not require the agreement of the policyholder. The need to notify the other party to exercise the option does not mean their agreement is required. Examples include:

- changes to premium or benefits permitted under terms of the contract, law or regulation. Note,
  - if the policyholder has the right to terminate the contract upon such a change, this does not mean agreement of both parties is required for the insurer to exercise the right to make such changes, simply that it gives the policyholder rights. In both cases, they can be exercised without the agreement of the other party and hence these are not contract modifications; and
  - where the insurer has the right or practical ability to change the premium in such a way that the payment of that premium is outside of the boundaries of the contract (see Chapter 1 – Classification of Contracts), then it creates a new contract that is measured as such.

14.4. What about the exercise of a contractual option to add a feature that is outside the contract boundary?

A special case may occur if there is a contractual right to add a new feature to the original contract which could be outside the contract boundary when the entity is able to reprice or underwrite the contract for the additional feature added at the time it is added.

IFRS 17 treats cash flows outside the contract boundary as relating to future insurance contracts (paragraph 35), and such a new feature might be eligible to be treated as a new contract.

The treatment of contractual options and their interaction with the contract boundary was discussed at the IASB May 2018 TRG meeting (see AP03 Cash flows within the contract boundary and the IASB Summary of the May TRG Meeting).

This discussion raised the potential for a range of interpretations regarding the treatment of contractual options.

One view is that unless the contractual option of itself, even before exercise, qualifies as a separate contract, then it is a contractual feature of the insurance contract. (See IASB Feb 18 TRG paper AP01 - Separation of insurance components of a single insurance contract and IASB TRG summary for the limited circumstances in which this may apply.) In such a case, it is included in measurement of the original contract to the extent it is within the contract boundary, as the unit of account is the contract as a whole, and thus the contract boundary depends on the substantive rights and obligations as a whole.

The ability to reprice a part of the contract (e.g., the feature being added on exercise of the option) does not mean that part has a different contract boundary.

An alternative view is that if the terms of the addition were not guaranteed, then that of itself is sufficient for the addition to be outside the boundary of the original contract. An entity would need to decide whether to adopt the staff view or the alternative TRG view when assessing if there is any contractual obligation that needs to be measured prior to exercise. Also, it may not be practicable where the addition is not distinct (i.e., the cash flows of the new feature and the original contract are highly interrelated) to treat it as a separate new contract.

If not distinct, then the addition of new features that are outside of the contract boundary (e.g., because they can be underwritten at the time of exercise at an appropriate price for the change in insurance risk, if the alternative TRG view is taken) might be treated as a contract modification at the time of addition, as the ability to underwrite the new feature effectively means the consent of both parties is required.

If the contract modification is not a specified modification under paragraph 72, then paragraph 73 applies (i.e., the contract is not de-recognised and the changes in cash flows caused by the modification are treated as changes in estimates of fulfilment cash flows).

Specified Modifications

14.5. Which are the specified contract modifications that result in the derecognition of the original and recognition of the modified contract as a new contract?

These are those contract modifications specified in paragraph 72 referred to here as "specified contract modifications" . The discussion in the Basis for Conclusions (see paragraphs BC317-BC320) indicates that the criteria in paragraph 72 capture modifications that the IASB sees as resulting in significantly different accounting treatment. For example, if the modified terms had applied at inception, they would have caused differences in the applicability of IFRS 17, the separation of components, the contract boundary (only if substantially different), or the applicability of the measurement model of the original contract (i.e., use of premium allocation approach, "PAA", vs. general measurement approach, "GMA").

The specified criteria in paragraph 72 are such that had the contract been written at inception as now modified, it would have:

- Been excluded from the scope of IFRS 17 (see Chapter 1 – Classification of Contracts);
- Been included in a different group from the one it was included in at initial recognition;
- A substantially different contract boundary;
- Different components separated, resulting in a different insurance contract for IFRS 17;

- Not qualified for the PAA that was applied to the original contract (see Chapter 7– Premium Allocation Approach); or
- Qualified (or ceased to qualify) for treatment as an insurance contract with direct participation features.

14.6. How do contract modifications or the exercise of options available under the contract influence the contract boundary?

The contract boundary is re-assessed in each reporting period (see paragraph B64) and ends when the criteria of paragraphs 34 are fulfilled (see Chapter 1 – Classification of Contracts). Options and contract modifications form part of the reassessment in each reporting period.

Accounting for specified contract modifications

14.7. How are specified contract modifications accounted for?

The entity:

(a) derecognises the contract being modified from the group to which it was allocated at inception by:

- setting the contribution of its fulfilment cash flows, including the risk adjustment for non-financial risk and incurred claims, to the group to zero (paragraph 76 (a));
- adjusting the number of coverage units for expected remaining coverage (paragraph 76(c));
- adjusting the CSM of the group to the extent required by paragraphs 44(c) and 45(c) for the difference between (paragraph 77(a)):
  - the reduction in fulfilment cash flows of the group from setting that for the contract prior to modification to zero (paragraph 77(a)(i)); and
  - the premium it would have charged for a new contract issued at the date of contract modification with equivalent terms, net of any additional premium charged for the modification (paragraph 77(a)(iii)).
- per paragraphs 44(c) and 45(c), the CSM can only be adjusted to the extent that the adjustment does not reduce the CSM below zero, except in the case of reinsurance held. If there is a loss component already, paragraphs 44(c)(ii), 45(c)(iii) and 50(b) apply;

and

(b) recognises the modified contract as a new contract as at the date of modification under IFRS 17 assuming the net equivalent premium noted above was paid as at the date of modification (see paragraph 77(b)).

Paragraph 77 (a)(ii) does not apply here since it relates to transfers to a third party (see Q 14.14).

14.8. If the insurer does not have contracts with equivalent terms, how is the premium determined?

The premium is the price that the entity would have charged the policyholder if it had entered into a contract with equivalent terms at the date of the actual modification (see paragraph 77(a)(iii)), less any additional premium charged for the modification.

The assumptions used in determining the premium would usually be consistent with those used in determining the liability arising from the modified contract at the date of actual modification, except for the CSM.

For example, the premium might be determined as the sum of:

- the fulfilment cash flows (the unbiased expected present value of the future cash flows, excluding the premium being determined and including any taxes on the premium, acquisition costs for the modified contract, and an adjustment for risk);
- any other elements, other than profit targets, not included in fulfilment cash flows under IFRS 17 that the entity would normally include in setting premiums, e.g., general overheads and costs not directly attributable to a portfolio of insurance contracts and charge for capital; and
- the CSM after allowing for any elements not included in fulfilment cash flows, that reflects the entity's current approach to profit targets when pricing for similar business.

Note, this may not be the same as the fair value of the modified contract, and the premium possibly could differ from fair value because:

a. it uses entity-specific assumptions for some inputs, including the degree of risk aversion, whereas fair value typically uses market participant assumptions in all cases;

b. it excludes the entity's own non-performance risk, whereas fair value would include the entity's own non-performance risk; and

c. it includes the entity's targets for CSM, whereas fair value includes no such margin, although fair value implicitly includes a current value for any additional margin that market participants would require.

Other contract modifications

14.9. What other types of contract modifications are there?

Apart from specified contract modifications, as per paragraph 72, there are other contract modifications. Examples could include, but are not limited to:

- Addition or removal of benefits, where they do not cause the contract to fall into another portfolio and hence different group;
- Increase or reduction in benefits, where they do not change grouping;

- Changes to what is covered, e.g., an extension or renovation under home insurance, or a new car under motor insurance; or
- Extension or reduction of the contract term, with no substantial change in benefit levels, provided this does not materially change the contract boundary or change eligibility for PAA.

14.10. How are other contract modifications accounted for?

Contract modifications not specified in paragraph 72 are accounted for by treating the resulting changes in the fulfilment cash flows (i.e., expected cash flows, risk adjustment) as a change in estimates as per paragraphs 40-52 (see paragraph 73).

14.11. How are changes that are not contract modifications treated?

Changes that are not contract modifications (see question 14.3) form part of the expected cash flows under the contract (see Chapter 2 – Estimates of Future Cash Flows) so long as they are within the contract boundary (see Chapter 1). Hence, they are considered when:

a. measuring the contract upon initial recognition under paragraphs 32 -35, paragraphs B61 and B62 (i.e., possible future changes due to changes that are not contract modifications are considered in the future cash flows at initial recognition); and

b. upon subsequent measurement under paragraph 40.

Derecognition

14.12. When can contracts be derecognised?

Contracts can be derecognised only when:

- A specified contract modification occurs (see question 14.5), in this case the modified contract is treated as a new contract which assumes all obligations arising from the contract pre and post modification; or
- A contract is transferred to a third party (see paragraph 77 and question 14.14), this applies only when the contract is transferred as a whole including any obligation for incurred claims arising from past coverage, otherwise the contract in full has not been extinguished and cannot be derecognised as per paragraph 74; or
- All obligations under the contract are extinguished (see question 14.15). This includes not only the liability for future coverage but also for incurred claims arising from past coverage (see paragraph 74(a)).

14.13. How are contracts that are transferred to a third party derecognised?

In a similar way to the derecognition of a contract upon a specified contract modification (per the paragraph 72 criteria) that is the contract being transferred is derecognised from the group to which it was allocated at inception by:

- setting the contribution of its fulfilment cash flows (including the risk adjustment and incurred claims) to the group to zero;

- adjusting the number of coverage units (see paragraph 76(c))
- adjusting the CSM of the group for the difference between:
    - the reduction in the insurance contract liability of the group as a result of setting the fulfilment cash flows of the contract being transferred to zero; and
    - the premium charged by the third party for transfer of the contract.

14.14. How are contracts derecognised other than due to a specified contract modification or transfer to a third party?

In a similar way to the derecognition of a contract upon a specified contract modification (per paragraph 72 criteria), that is the contract is derecognised from the group to which it was allocated at inception by:

- setting the contribution to fulfilment cash flows (including the risk adjustment and incurred claims) to the group to zero;
- adjusting the number of coverage units (paragraph 76(c)); and
- adjusting the CSM of the group for the reduction in fulfilment cash flows of the group as a result of setting that element of the fulfilment cash flows relating to future service to zero in respect of the contract being derecognized.

14.15. What if a modified contract was part of an onerous group?

If the modification is not specified in paragraph 72, then paragraph 73 applies and the changes in estimates of fulfilment cash flows are treated in accordance with paragraphs 50 and 51 in the same way as any other subsequent change in fulfilment cash flows under IFRS 17.

If the modification is specified in paragraph 72, then it is treated as per paragraphs 74-77, (see Question 14.8) and there is no CSM to be adjusted in respect of the group to which the contract was allocated at inception (since this group is by prerequisite of the question onerous and hence there is no CSM), unless the modified contracts contained the ones that finally caused the group to be onerous, in this case a CSM might re-appear.

As noted in Question 14.8 the modification is allocated to the loss component of the group as required by paragraphs 44(c)(ii), 45(c)(iii) and 50(b) unless measured under PAA.

14.16. What if only the obligation for future coverage is transferred to a third party?

In this case, if there is remaining obligation for coverage already provided, the contract does not qualify for derecognition under paragraph 77 and is treated as a contract modification. However, if there is no liability for remaining coverage, then it would qualify for derecognition.

Application to reinsurance and premium allocation approach

14.17. How are modifications to reinsurance contracts accounted for?

Reinsurance contracts are insurance contracts and the modifications to them are accounted for in the same way as for other insurance (paragraph 4), see also chapter 9.

14.18. How do modifications to underlying insurance contracts affect the subsequent measurement of the reinsurance contract?

To the extent that they change the expected cash flows under the reinsurance contract, they are:

- reflected in the re-measurement of the reinsurance contract (as per paragraphs 40–46 and 60–68); and
- not reflected in the CSM of the reinsurance contract to the extent that they do not adjust the CSM of the underlying group of insurance contracts (see paragraph 66(c)) and relate to future service.

14.19. How are contract modifications and derecognition accounted for under the PAA?

The requirements of paragraphs 73, 76 and 77 presume that the contract is being measured under the GMA. Where PAA applies to a contract (and in the case of a contract modification it continues to qualify for PAA), IFRS17 provides no definite guidance on the applicability of these paragraphs and the entity would have to develop an appropriate accounting policy as per paragraphs 10 to 12 of IAS 8.

Hence there are a number of various possible interpretations that could be adopted as applying to these circumstances.

For example, one possible, but unlikely, interpretation might be that they have no effect for PAA contracts.

Another example of a possible approach might be to apply the requirements of paragraphs 73, 76 and 77 appropriately modified for PAA, e.g.,

(a) For non-specified contract modifications, as per the answer to questions 14.12 and 14.15, (because a change in estimates under PAA only impacts the liability for incurred claims as per paragraph 40 (b)) this element would reflect this change if appropriate. However, if the contract modification where to:

  (i) cause the group of which it is a part to be viewed as onerous, paragraphs 57 and 58 would apply and liability for remaining coverage would also change as per these paragraphs; or

  (ii) cause the premiums received to change then this would be reflected in the liability for remaining coverage as per paragraph 55.

(b) For specified contract modifications, the answer to question 14.8 applies, modified for PAA as follows:

  (i) de-recognises the modified contract from the group of which it is part by setting the contribution of its carrying value to the group including liability for incurred claims to zero, consistent with paragraph 76 (a); and

  (ii) recognises the modified contract as a new contract as at the date of modification under IFRS 17 assuming the premium it would have charged for a new contract issued at the date of contract modification with equivalent

terms, net of any additional premium charged for the modification (paragraph 77(a)(ii)) was received as at the date of modification (paragraph 77(b)).

(c) When derecognising a contract, the answer to Question 14.15 applies, modified for PAA as per (b) (i) above.

(d) When derecognising a contract upon transfer to another party, the answer to Question 14.14 applies, modified for PAA as per (b)(i) above.

Section E – Presentation and Disclosure

This Section includes three chapters that outline requirements for presentation and disclosure of financial information under IFRS 17 and provide guidance for actuaries on how these areas of communication may be interpreted.

Before consulting this section and its three chapters, be sure to read the Introduction to this IAN, particularly the sections on References to IFRS 17, Materiality and Proportionality.

This section comprises of the following chapters:

Chapter 15 – Definitions: i.e., introduction and explanation of key terms relevant to the financial reporting of (re)insurance contracts issued and reinsurance contracts held:

- Explanation of the term "Presentation"
- Explanation of the term "Disclosure"
- Explanation of additional key terms

Chapter 16 – Presentation requirements outlined in IFRS 17– *Insurance Contracts*

- General introduction
- Presentation requirements in the Statement of Financial Position
- Presentation requirements in the Statement of Financial Performance

Chapter 17 – Disclosure requirements under IFRS 17 – *Insurance Contracts*:

- General introduction
- Explanation of reconciled amounts (reconciliations), including the specific disclosure requirements under different measurement approaches.
- Discussion of disclosures in areas where significant judgements are required
- Discussion of specific disclosure requirements relating to recognising the nature and extent of risk

To the extent not covered in IFRS17 explicitly, the overarching principles for presentation of financial information are outlined in IAS 1 – *Presentation of Financial Statements*. Additional IFRS Standards might be applicable (such as IFRS 10 – *Consolidated Financial Statements*; IFRS 8 – *Operating Segments*, and IFRS 7 – *Financial Instrument: Disclosures*) as well as additional IAS Standards (such as IAS 8 - *Accounting Policies, Changes in Accounting Estimates and Errors*, and IAS 34 – *Interim Financial Reporting*) depending on the specific circumstances of the reporting entities.

In preparing this Section, we have leveraged from existing global publications by EY, KPMG, and PWC that focus on IFRS 17 Illustrative Financial Statements.

Note that there are certain accounting policy choices and/or options applied when preparing specific illustrative examples used in this chapter. Illustrations published by any of the

accounting firms referenced do not necessarily imply interpretations or accounting policy choices that an entity might elect when producing a set of financial statements.

A. Which paragraphs within the IFRS 17 Standard address presentation and disclosure requirements?

The following table contains an overview of the relevant paragraphs in the main body of IFRS 17 – Insurance Contracts:

ID	Topic	Paragraphs in IFRS 17
a)	Presentation in the statement of financial position	78–79
b)	Presentation in the statement of financial performance	80–92
c)	Disclosure requirements	93–132

Paragraphs B120 - B137 provide additional guidance on the application of the presentation requirements.

Paragraphs BC328 - BC366 provide background on the topic of presentation and disclosure of (re)insurance contracts issued and reinsurance contracts held.

B. What other IAA documents are relevant to this topic?

None

C. What might be the role of an actuary helping to produce IFRS 17 presentation and disclosures?

Typically, the finance or accounting team will have ultimate responsibility for the information contained in the financial statements, including the disclosures. The actuary's role in preparing disclosures is likely to be a supporting role to the individual or team responsible for preparing the overall financial statements. This may include:

- Preparing numerical information specific to the disclosures that is not recorded in core finance systems or which is sourced from actuarial models – for example, historic claims development (and the reasons for such development) and sensitivities to insurance and market risks.
- Supporting the preparation of, or reviewing, qualitative information included in the disclosures – for example, qualitative information on how the entity manages the various types of risk to which it is exposed.
- Review of other qualitative or quantitative information included in the financial statements to support the overall integrity of the disclosures and to ensure that the information included presents a fair and accurate representation of the effect of the contracts within the scope of IFRS 17 at the reporting date.

Chapter 15 – Introduction and Explanation of Key Terms Relevant to the Financial Reporting of (Re)insurance Contracts Issued and Reinsurance Contracts Held.

15.1. What is meant by the term 'presentation' in an IFRS 17 context?

To understand the presentation requirements for (re)insurance contracts issued and reinsurance contracts held under IFRS 17, it is relevant to consider IAS 1 – Presentation of Financial Statements. IAS 1 sets out the general requirements for presentation of financial statements within the IFRS Framework.

Paragraph 10 of IAS 1 sets out what a complete set of financial statements comprises:

- The statement of financial position, which is traditionally referred to as the balance sheet under other reporting bases, and
- The statement of financial performance, which is – in combination – referred to as the statement of profit or loss (P&L) and the statement of other comprehensive income (OCI).
- Statement of Changes in Equity
- Statement of Cash Flows

The statement of financial performance can be thought of as consisting of three key parts.

1. The first part presents any sources of income and expenses that are included in P&L and it ends with the assessment of P&L for the period.
2. The second part presents any sources of OCI (that do not contribute to P&L).
3. As a sub-total, both parts contribute to a total assessment of "comprehensive income" for the reporting period at the bottom of the statement.

The relevant paragraphs in IFRS 17 define the actual line items for both, the statement of financial position as well as the statement of financial performance.

15.2. What is meant by the term 'disclosure' in IFRS 17?

Presentation requirements generally do not provide sufficient information for investors and other users of financial statements to make elaborate economic and investment decisions. The IFRS Framework is focusing on the principles of creating sets of general-purpose financial statements. In addition, these require the disclosure of notes which have the objective of supporting a meaningful comparison between different entities.

Paragraph 93 specifies that the objective of the disclosure requirements within IFRS 17 is to give a "*basis for users of financial statements to assess the effect that contracts within the scope of IFRS 17 have on the entity's financial position, financial performance and cash flows*".

Disclosure items, in the context of IFRS 17, cover the following three key areas:

1. *the amounts recognised in its financial statements for contracts within the scope of IFRS 17 (see paragraphs 97 – 116);*
2. *the significant judgements, and changes in those judgements, made when applying IFRS 17 (see paragraphs 117 – 120); and*
3. *the nature and extent of the risks from contracts within the scope of IFRS 17 (see paragraphs 121 – 132).*

15.3. What are the key terms relevant to this chapter?

The statement of financial performance contains the P&L statement as well as the OCI Statement as outlined above.

With respect to these statements, the following key terms are introduced in IFRS 17.

- Insurance Service Result

  The insurance service result (paragraphs 83-86 and B120-B127), includes:

  - Insurance revenue: This quantity comprises the release of expected claim and other expense cash flows, including an allocation for acquisition expenses, the release of CSM and release of risk adjustment for the period; and
  - Insurance service expense: This quantity comprises the actual incurred claims and other expenses, including acquisition expenses matching the amounts included in insurance revenue, for the period.

- Net expense from reinsurance contracts held (Paragraph 86)

  The net expense from reinsurance contracts held consists separately of the:

  - Allocation of reinsurance premiums
  - Amounts recoverable from reinsurers for incurred claim

  IFRS 17 requires measuring and presentation of insurance contracts separately from reinsurance contracts. These requirements impact the presentation of reinsurance contracts held (which can be a net gain or a net loss) in the statement of financial performance for both, the insurance service result and the finance result.

  In presenting the net expense from reinsurance contracts held, IFRS 17 allows an entity to either present the amounts recovered separately from the amount of premium paid, or to present the net amount of these two components.

  There are differing interpretations of how Insurance Service Result is defined and presented with regard to reinsurance. This is discussed in Question 16.5.

- Insurance finance income or expenses (IFIE)

  The insurance finance income or expenses (refer to paragraphs 87 – 92 and B128 – B136) covers:

  a) the effect of the time value of money and changes thereof; and
  b) financial risk and changes thereof.

- Net insurance financial results

  Since reinsurance contracts are measured separately from insurance contracts, there will be a separate line item for reinsurance finance income or expense on the statement of financial performance.

  The net insurance financial results represent the netted amount of the IFIE positions as shown in the example in section 16.4 below:

  Note that the line-item profit before tax ultimately consists of the sum of the following:

  - Insurance service result, consisting of:
    - Insurance service result before reinsurance contracts held;
    - Net expense from reinsurance contracts held
  - Total investment income;
  - Net insurance financial result; and
  - Other income and expenses.

  This item will not be discussed further in this chapter.

15.4. What principles of materiality apply to IFRS 17 presentation?

There is an IFRS Practice Statement on Making Materiality Judgements (IFRS Practice Statement 2). Information on this can be found on the IASB website here: https://www.ifrs.org/issued-standards/materiality-practice-statement/

An entity applying IFRS 17 will already have an overall framework of setting materiality amounts in the context of producing a set of financial statements. IFRS 17 does not introduce the term materiality nor does it impose a higher hurdle or barrier for the production of a set of financial statements. Even though IFRS 17 might be perceived as more complex than other IFRSs, the same materiality judgements will apply as for the application of any other IFRSs.

Chapter 16 – Presentation Requirements Outlined in IFRS 17 Insurance Contracts

16.1 What are the key areas of presentation required under IFRS 17?

IFRS 17 specifies minimum amounts of information that need to be presented on the face of the statement of financial position and statement of financial performance. These are supplemented by disclosures to explain the amounts recognised on the face of the primary set of financial statements.

IFRS 17 requires separate presentation of amounts relating to (re)insurance contracts issued and reinsurance contracts held in the set of primary financial statements. IFRS 17 does not limit an entity from providing further sub-divisions of the required line items. This may aid in making the relationship of the reconciliations to the face of the statement of financial position more easily understandable.

The table below summarises the presentation requirements under IFRS17 according to these areas.

Areas required for presentation	Item	IFRS 17 Reference	IAN 100 Reference
(a) Presentation in the statement of financial position	Net asset or liability position carrying amounts	Paragraph 78	16.2
	Assets for insurance acquisition cash flows	Paragraph 79	16.3
(b) Presentation in the statement(s) of financial performance	General requirements	Paragraphs 80-82	16.4
	Insurance service result (ISE)	Paragraphs 83-86	16.4 (a)
	Insurance finance income or expenses (IFIE)	Paragraphs 87-91	16.4 (b)

Presentation in the statement of financial position

16.2 What are the overarching presentation requirements on the statement of financial position for an entity issuing or holding insurance and/or reinsurance contracts?

For measurement, paragraph 24 indicates that an entity shall apply the recognition and measurement of a (re)insurance contract at a group level Paragraph 78 sets out that an entity shall present separately in the statement of financial position the carrying amounts of:

a. Portfolios of insurance contracts issued that are net assets;

b. Portfolios of insurance contracts issued that are net liabilities;

c. Portfolios of reinsurance contracts held that are net assets; and

d. Portfolios of reinsurance contracts held that are net liabilities.

16.3 How is the insurance acquisition cash flows arising from paragraph 28A presented on the statement of financial position?

IFRS 17 requires an entity to consider acquisition costs in determining the expected profit of insurance contracts. According to paragraph 28B, the entity considers these costs by recognising them:

- as an asset until the contracts are recognised; or
- by including them in the cash flows expected to fulfil the insurance contracts if the group of contracts is already recognised.

In respect to the presentation of this asset, paragraph 79 requires an entity to add any asset for insurance acquisition cash flows to the carrying amount of the related portfolios. In other words, the asset is not presented separately on the statement of financial position.

Presentation in the statement of financial performance

16.4 What line items are required in the statement of financial performance?

Paragraph 80 requires that, for insurance contracts, the entity includes the following line items in the statement of financial performance (discussed in Question 15.3)

a) Insurance Service Result

b) Insurance finance income or expenses (IFIE)

There are at least two interpretations of how reinsurance held is to be presented under IFRS 17. Under one interpretation, the net expense from reinsurance contracts held is treated as a separate expense category in determining the insurance service result. In another interpretation, an insurer first calculates the insurance service result before reinsurance contracts held, and then shows the net expense from reinsurance contracts held. Under this interpretation, the insurance service result is then the sum of:

a) the insurance service result (before reinsurance contract held); and

b) the net expense from reinsurance contracts held.

An example of the Financial Statements under the two interpretations is as follows:

Showing insurance service result before reinsurance

Statement of profit or loss and other comprehensive income

For the year ended 31 December 2021

In €000	**Notes**	**2021**	**2020 *restated***	*IAS 1.81A, IAS 1.9(d), IAS 1.10(b), IAS 1.51(b)-(e) IAS 1.29, IAS 1.32 IAS 1.104, IAS 1.46, IAS 1.45*
Insurance revenue	6	2,581	2,293	*IAS 1.82(a)(ii), IFRS 17.83*
Insurance service expense	12	(1,541)	(1,411)	*IAS 1.82(ab), IFRS 17.84*
Insurance service result before reinsurance contracts held		**1,040**	**882**	
Allocation of reinsurance premiums	7	(448)	(546)	*IFRS 17.86*
Amounts recoverable from reinsurers for incurred claims		279	348	*IFRS 17.86*
Net expense from reinsurance contracts held	7	**(169)**	**(198)**	*IAS 1.82(ac), IFRS 17.82*
Insurance service result		**871**	**684**	*IFRS 17.80(a)*
Interest revenue calculated using the effective interest method		831	622	*IAS 1.82(a)(i)*
Other interest and similar income		366	299	
Net fair value gains/(losses) on financial assets at fair value through profit or loss		104	(14)	*IFRS 7.20(a)(i)*
Net fair value gains/(losses) on derecognition of financial assets measured at fair value through other comprehensive income		6	-	*IAS 1.82(aa)*
Impairment loss on financial assets		(5)	(2)	*IAS 1.82(ba)*
Net foreign exchange (expense) / income		(50)	22	
Total investment income	**8**	**1,252**	**927**	
Insurance finance expenses for insurance contracts issued	8	(742)	(673)	*IAS 1.82(bb), IFRS 17.87*
Reinsurance finance income for reinsurance contracts held	8	98	119	*IAS 1.82(bc), IFRS 17.82*
Net insurance financial result		**(644)**	**(554)**	
Other income and expense		(210)	(191)	
Profit before tax		**1,269**	**866**	

Statement of profit or loss and other comprehensive income

For the year ended 31 December 2021

In €000	**Notes**	**2021**	**2020 *restated***	*IAS 1.81A, IAS 1.9(d), IAS 1.10(b), IAS 1.51(b)-(e) IAS 1.29, IAS 1.32 IAS 1.104, IAS 1.46, IAS 1.45*
Insurance revenue	6	2,581	2,293	*IAS 1.82(a)(ii), IFRS 17.83*
Insurance service expense	12	(1,541)	(1,411)	*IAS 1.82(ab), IFRS 17.84*
Insurance service result before reinsurance contracts held		**1,040**	**882**	
Allocation of reinsurance premiums	7	(448)	(546)	*IFRS 17.86*
Amounts recoverable from reinsurers for incurred claims		279	348	*IFRS 17.86*
Net expense from reinsurance contracts held	7	**(169)**	**(198)**	*IAS 1.82(ac), IFRS 17.82*
Insurance service result		**871**	**684**	*IFRS 17.80(a)*

Source: EY's Illustrative Financial Statements

Showing reinsurance as a component of the insurance service result (along with the rest of the profit or loss statement) –

Consolidated statement of profit or loss

		Note	Year ended 31 December 20X4	20X3
IFRS 17(80)(a),(83) IAS 1(82)(a)	Insurance revenue	2.4.1	114,845	93,252
IFRS 17(80)(a),(84) IAS 1(99)	Insurance service expenses	2.4.1	(101,256)	(81,959)
IFRS 17(82),(86)	Net expenses from reinsurance contracts held	2.4.1	(5,849)	(3,859)
IFRS 17(80)(a)	**Insurance service result**		**7,740**	**7,434**
IFRS 7(20)(b) IAS 1(82)(a)	Interest revenue from financial assets not measured at FVTPL	3.5	2,696	2,321
	Net gains on FVTPL investments	3.5	11,129	8,214
IFRS 7(20)(a)(viii)	Net gains on investments in debt securities measured at FVOCI reclassified to profit or loss on disposal	3.5	78	51
IFRS 7(20)(a)(i)	Net change in investment contract liabilities	3.4, 3.5	(756)	(672)
IFRS 7(20A) IAS 1(82)(aa)	Net gains from the derecognition of financial assets measured at AC	3.5	22	13
IAS 40(76)(d)	Net gains from fair value adjustments to investment properties	3.5	157	552
IAS 1(82)(ba)	Net credit impairment losses	3.5, 3.7	(40)	(31)
	Net investment income		**12,286**	**10,448**
IFRS 17(80)(b)	Finance expenses from insurance contracts issued	3.5	(7,228)	(3,804)
IFRS 17(80)(b),(82)	Finance income from reinsurance contracts held	3.5	1,610	501
	Net insurance finance expenses		**(5,618)**	**(3,303)**
	Net insurance and investment result		**15,408**	**14,579**
IAS 1(82)(a)	Asset management services revenue		1,133	888
IAS 1(82)(b)	Other finance costs		(2,283)	(1,962)
IAS 1(99),(103)	Other operating expenses	5	(3,949)	(3,099)
IAS 1(82)(c)	Share of profit of associates and joint ventures accounted for using the equity method		463	365
	Profit before income tax		**10,772**	**10,771**
IAS 1(82)(d) IAS 12(77)	Income tax expense		3,155	3,087
IAS 1(81A)(a)	**Profit for the year**		**7,617**	**7,684**
IAS 1(81B)(a)	**Profit attributable to**			
	Owners of Value Insurance Plc		7,451	7,480
	Non-controlling interests		166	204
IAS 33(66)	**Earnings per share for profit attributable to the ordinary shareholders (in CU per share)**			
	Basic earnings per share		0.35	0.39
	Diluted earnings per share		0.32	0.36

Source: PWC's Illustrative Financial Statements

16.5 Are there specific presentation requirements for insurance revenue?

IFRS 17 requires that insurance revenue and insurance service expenses exclude investment components (refer to paragraphs 42(a), 84, 85,103(b)(i)), B120, B123(a)(ii), B124(a)(ii)). Paragraph 103 (c) requires that investment components excluded from

insurance revenue and insurance service expenses are disclosed separately in the reconciliations.

Paragraph B124 sets out that insurance revenue is for the reduction in the liability for remaining coverage because of services provided in the period. Consequently, only premiums in respect of service provided in the period would be included in revenue for that period. This may include premiums that have fallen due but have not yet been received, for example, from brokers where balances are settled quarterly or where adjustment premiums are paid at the end of the coverage period relating to changes in exposure across the entire reporting period.

16.6 What is included in insurance service expenses?

The items included in insurance service expenses are identified in paragraph 103b as.

i. Incurred claims (excluding investment components) and other incurred insurance service expenses;

ii. amortisation of insurance acquisition cash flows;

iii. changes that relate to past service, i.e., changes in fulfilment cash flows relating to the liability for incurred claims; and

iv. changes that relate to future service, i.e., losses on onerous groups of contracts and reversals of such losses.

An example is as follows:

29. Insurance and reinsurance contracts (continued)

A. Movements in carrying amounts (continued)

ii. Life savings

Insurance contracts

Analysis by remaining coverage and incurred claims

In millions of euro	Note	2021 Liabilities for remaining coverage: Excluding loss component	2021 Liabilities for remaining coverage: Loss component	2021 Liabilities for incurred claims	2021 Total	2020 Liabilities for remaining coverage: Excluding loss component	2020 Liabilities for remaining coverage: Loss component	2020 Liabilities for incurred claims	2020 Total
Opening liabilities		67,699	2,571	334	70,604	63,590	2,424	338	66,352
Changes in the statement of profit or loss and OCI									
Insurance revenue									
Contracts under the modified retrospective approach		(1,895)	-	-	(1,895)	(1,717)	-	-	(1,717)
Other contracts		(596)	-	-	(596)	(424)	-	-	(424)
		(2,491)	-	-	(2,491)	(2,141)	-	-	(2,141)
Insurance service expenses									
Incurred claims and other insurance service expenses		-	(40)	371	331	-	(75)	323	248
Amortisation of insurance acquisition cash flows		696	-	-	696	633	-	-	633
Losses and reversal of losses on onerous contracts		-	8	-	8	-	44	-	44
Adjustments to liabilities for incurred claims		-	-	(8)	(8)	-	-	12	12
		696	(32)	363	1,027	633	(31)	335	937
Investment components		(7,374)	-	7,374	-	(6,230)	-	6,230	-
Insurance service result		(9,169)	(32)	7,737	(1,464)	(7,738)	(31)	6,565	(1,204)
Net finance expenses from insurance contracts		4,221	166	24	4,411	3,990	159	21	4,079
Effect of movements in exchange rates		(267)	(11)	(12)	(290)	377	19	4	400
Total changes in the statement of profit or loss and OCI		(5,215)	123	7,749	2,657	(3,466)	147	6,590	3,269
Cash flows									
Premiums received		10,073	-	-	10,073	8,181	-	-	8,181
Claims and other insurance service expenses paid, including investment components		-	-	(7,737)	(7,737)	-	-	(6,594)	(6,594)
Insurance acquisition cash flows		(686)	-	-	(686)	(604)	-	-	(604)
Total cash flows		9,387	-	(7,737)	1,650	7,577	-	(6,594)	983
Closing liabilities		71,871	2,694	346	74,911	67,699	2,571	334	70,604

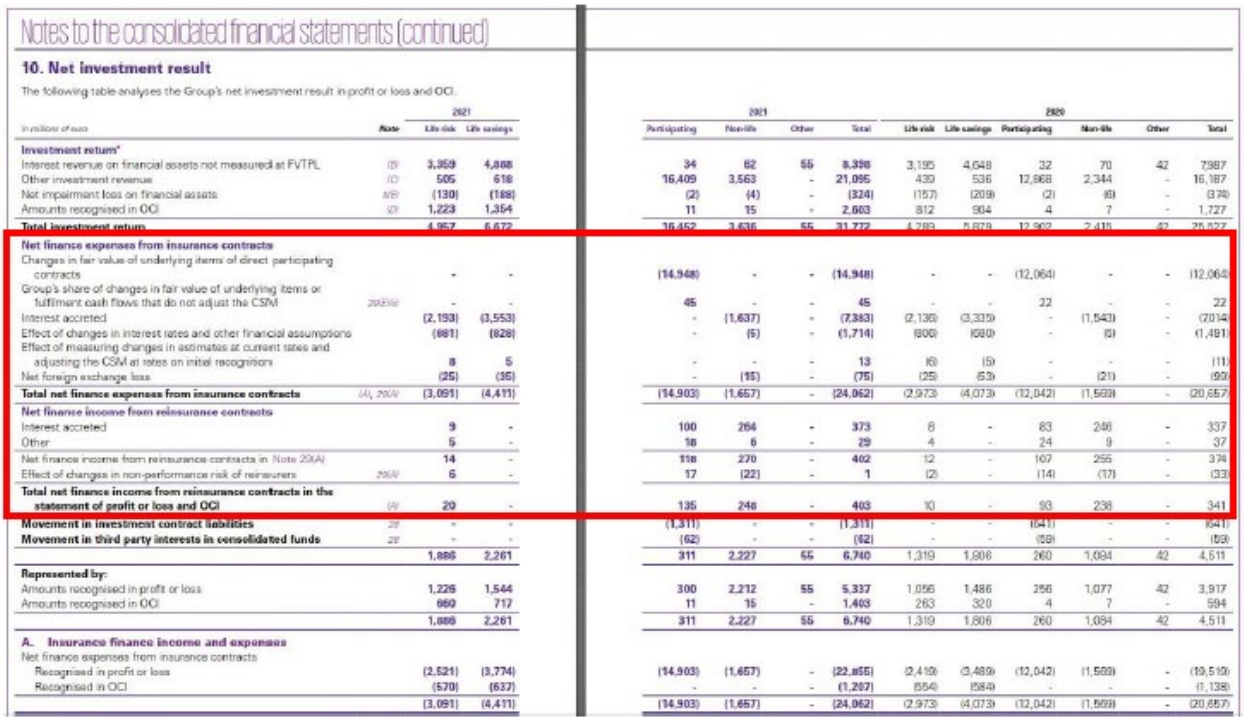
Source: KMPG's Illustrative Financial Statements

16.7 What is the IFIE and how can it be presented in the statement of financial performance?

IFIE is defined as the change in insurance contract liabilities arising from the effect of or changes to the time value of money (meaning, the unwinding of the discount applied to the fulfilment cash flows, changes in the discount rates applied to the fulfilment cash

flows, and the accretion of interest on the CSM), and the effect of financial risk or changes in financial risk.

An example is as follows:



Notes to the consolidated financial statements (continued)

10. Net investment result

The following table analyses the Group's net investment result in profit or loss and OCI.

In millions of euro	Note	2021 Life risk	2021 Life savings	2021 Participating	2021 Non-life	2021 Other	2021 Total	2020 Life risk	2020 Life savings	2020 Participating	2020 Non-life	2020 Other	2020 Total
Investment return*													
Interest revenue on financial assets not measured at FVTPL	(D)	3,359	4,888	34	62	55	8,398	3,195	4,648	32	70	42	7,987
Other investment revenue	(C)	505	618	16,409	3,563	-	21,095	439	536	12,868	2,344	-	16,187
Net impairment loss on financial assets	(E)	(130)	(188)	(2)	(4)	-	(324)	(157)	(209)	(2)	(6)	-	(374)
Amounts recognised in OCI	(O)	1,223	1,354	11	15	-	2,603	812	904	4	7	-	1,727
Total investment return		4,957	6,672	16,452	3,636	55	31,772	4,289	5,879	12,902	2,415	42	25,527
Net finance expenses from insurance contracts													
Changes in fair value of underlying items of direct participating contracts		-	-	(14,948)	-	-	(14,948)	-	-	(12,064)	-	-	(12,064)
Group's share of changes in fair value of underlying items or fulfilment cash flows that do not adjust the CSM	29(E)(a)	-	-	45	-	-	45	-	-	22	-	-	22
Interest accreted		(2,193)	(3,553)	-	(1,637)	-	(7,383)	(2,136)	(3,339)	-	(1,543)	-	(7,018)
Effect of changes in interest rates and other financial assumptions		(881)	(828)	-	(5)	-	(1,714)	(806)	(680)	-	(6)	-	(1,491)
Effect of measuring changes in estimates at current rates and adjusting the CSM at rates on initial recognition		8	5	-	-	-	13	(6)	(5)	-	-	-	(11)
Net foreign exchange loss		(25)	(35)	-	(15)	-	(75)	(25)	(53)	-	(21)	-	(99)
Total net finance expenses from insurance contracts	(A), 29(A)	(3,091)	(4,411)	(14,903)	(1,657)	-	(24,062)	(2,973)	(4,073)	(12,042)	(1,569)	-	(20,657)
Net finance income from reinsurance contracts													
Interest accreted		9	-	100	264	-	373	8	-	83	246	-	337
Other		5	-	18	6	-	29	4	-	24	9	-	37
Net finance income from reinsurance contracts in Note 29(A)		14	-	118	270	-	402	12	-	107	255	-	374
Effect of changes in non-performance risk of reinsurers	29(A)	6	-	17	(22)	-	1	(2)	-	(14)	(17)	-	(33)
Total net finance income from reinsurance contracts in the statement of profit or loss and OCI	(A)	20	-	135	248	-	403	10	-	93	238	-	341
Movement in investment contract liabilities	28	-	-	(1,311)	-	-	(1,311)	-	-	(641)	-	-	(641)
Movement in third party interests in consolidated funds	28	-	-	(62)	-	-	(62)	-	-	(59)	-	-	(59)
		1,886	2,261	311	2,227	55	6,740	1,319	1,806	260	1,084	42	4,511
Represented by:													
Amounts recognised in profit or loss		1,226	1,544	300	2,212	55	5,337	1,056	1,486	256	1,077	42	3,917
Amounts recognised in OCI		660	717	11	15	-	1,403	263	320	4	7	-	594
		1,886	2,261	311	2,227	55	6,740	1,319	1,806	260	1,084	42	4,511
A. Insurance finance income and expenses													
Net finance expenses from insurance contracts													
Recognised in profit or loss		(2,521)	(3,774)	(14,903)	(1,657)	-	(22,855)	(2,419)	(3,489)	(12,042)	(1,569)	-	(19,519)
Recognised in OCI		(570)	(637)	-	-	-	(1,207)	(554)	(584)	-	-	-	(1,138)
		(3,091)	(4,411)	(14,903)	(1,657)	-	(24,062)	(2,973)	(4,073)	(12,042)	(1,569)	-	(20,657)

Source: KMPG's Illustrative Financial Statements

16.8 What accounting policy choices can an entity make with regards to the IFIE, and are there any exceptions?

The entity can include the entire IFIE for the period in the P&L statement, or it can disaggregate the IFIE for the period between P&L statement and OCI.

If the entity chooses to disaggregate the IFIE for the period between P&L and OCI, the entity must define a systematic basis (paragraph 88(b)) to determine the OCI component (note: IFRS 17 does not prescribe what basis to use. Paragraphs B130-B132 provide detail on the assumptions and accounting treatment required if the OCI option is used by the entity. The entity would normally agree the approach with its auditor. The choice differs depending on the nature of the contract, whether non-participating (non-VFA contract), or direct participating (VFA contract).

For disclosure requirements related to the disaggregation of IFIE between P&L and OCI, see questions 17.17-17.19.

16.9 If the entity chooses to disaggregate IFIE into P&L and OCI, how should this disaggregation be made?

For contracts without direct participating features, use the methodology outlined in paragraphs B130-133. For direct participating contracts (VFA) use the methodology outlined in B134-136.

An example is as follows:

Statement of profit or loss and other comprehensive income

For the year ended 31 December 2021

In €000	**Notes**	**2021**	**2020 *restated***	*IAS 1.81A, IAS 1.9(d), IAS 1.10(b), IAS 1.51(b)-(e) IAS 1.29, IAS 1.32 IAS 1.104, IAS 1.46, IAS 1.45*
Insurance revenue	6	2,581	2,293	*IAS 1.82(a)(ii), IFRS 17.83*
Insurance service expense	12	(1,541)	(1,411)	*IAS 1.82(ab), IFRS 17.84*
Insurance service result before reinsurance contracts held		**1,040**	**882**	
Allocation of reinsurance premiums	7	(448)	(546)	*IFRS 17.86*
Amounts recoverable from reinsurers for incurred claims		279	348	*IFRS 17.86*
Net expense from reinsurance contracts held	7	**(169)**	**(198)**	*IAS 1.82(ac), IFRS 17.82*
Insurance service result		**871**	**684**	*IFRS 17.80(a)*
Interest revenue calculated using the effective interest method		831	622	*IAS 1.82(a)(i)*
Other interest and similar income		366	299	
Net fair value gains/(losses) on financial assets at fair value through profit or loss		104	(14)	*IFRS 7.20(a)(i)*
Net fair value gains/(losses) on derecognition of financial assets measured at fair value through other comprehensive income		6	-	*IAS 1.82(aa)*
Impairment loss on financial assets		(5)	(2)	*IAS 1.82(ba)*
Net foreign exchange (expense) / income		(50)	22	
Total investment income	8	**1,252**	**927**	
Insurance finance expenses for insurance contracts issued	8	(742)	(673)	*IAS 1.82(bb), IFRS 17.87*
Reinsurance finance income for reinsurance contracts held	8	98	119	*IAS 1.82(bc), IFRS 17.82*
Net insurance financial result		**(644)**	**(554)**	
Other income and expense		(210)	(191)	
Profit before tax		**1,269**	**866**	
Income tax expense		(231)	(172)	*IAS 1.82(d), IAS 12.77*
Profit for the year		**1,038**	**694**	*IAS 1.81A*
Other comprehensive income				
OCI to be reclassified to profit or loss in subsequent periods				*IAS 1.82A(a)(ii)*
Change in fair value of financial assets	8	179	(35)	*IFRS 7.20(a)(viii)*
Amount reclassified to profit or loss	8	(1)	2	*IFRS 7.20(a)(viii)*
Debt instruments at fair value through other comprehensive income	8	**178**	**(33)**	
Insurance finance expenses for insurance contracts issued	8	(194)	38	*IFRS 17.88(b), 89(b)*
Reinsurance finance income for reinsurance contracts held	8	56	(9)	*IFRS 17.82*
Net insurance financial result		**(138)**	**29**	
Income tax relating to items that may be reclassified		(8)	1	
Total other comprehensive income		**32**	**(3)**	
Total comprehensive income		**1,070**	**691**	

Source: EY's Illustrative Financial Statements

Notes to the Financial Statements

8. Total investment income and net insurance finance result

The table below presents an analysis of total investment income and insurance finance result recognised in profit or loss and OCI in the period:

IFRS 17.110

	2021			
		Insurance related	Non-insurance related	
In €000	**Life contracts**	**Reinsurance contracts issued**		**Total**
Investment income				
Amounts recognised in profit or loss				
Interest revenue calculated using the effective interest method	831	-	-	831
Other interest and similar income	-	366	-	366
Net gains/(losses) on financial assets at FVPL	-	104	-	104
Net gains/(losses) on derecognition of financial assets measured at FVOCI	6	-	-	6
Impairment loss on financial assets	(5)	-	-	(5)
Net foreign exchange income / (expense)	(50)	-	-	(50)
Total amounts recognised in the profit or loss	**782**	**470**	**-**	**1,252**
Amounts recognised in OCI	**178**	**-**	**-**	**178**
Total investment income	**960**	**470**	**-**	**1,430**
Insurance finance income / (expenses) from insurance contracts issued				
Interest accreted to insurance contracts using current financial assumptions	-	(289)	-	(289)
Interest accreted to insurance contracts using locked-in rate	(507)	-	-	(507)
Due to changes in interest rates and other financial assumptions	(195)	-	-	(195)
Net foreign exchange income / (expense)	55	-	-	55
Total insurance finance income / (expenses) from insurance contracts issued	**(647)**	**(289)**	**-**	**(936)**
Represented by:				
Amounts recognised in profit or loss	(453)	(289)	-	(742)
Amounts recognised in OCI	(194)	-	-	(194)
Reinsurance finance income / (expenses) from reinsurance contracts held				
Interest accreted to reinsurance contracts using locked-in rate	117	-	-	117
Due to changes in interest rates and other financial assumptions	56	-	-	56
Changes in risk non-performance reinsurer	(6)	-	-	(6)
Net foreign exchange income / (expense)	(13)	-	-	(13)
Reinsurance finance income / (expenses) from reinsurance contracts held	**154**	**-**	**-**	**154**
Represented by:				
Amounts recognised in profit or loss	98	-	-	98
Amounts recognised in OCI	56	-	-	56
Total net investment income, insurance finance expenses and reinsurance finance income	**467**	**181**	**-**	**648**
Represented by:				
Amounts recognised in profit or loss	427	181	-	608
Amounts recognised in OCI	40	-	-	40

Source: EY's Illustrative Financial Statements

For disclosure requirements related to the disaggregation of IFIE between P&L and OCI, see questions 17.17-17.19.

16.10 If the entity has disaggregated the IFIE between P&L and OCI, how should IFIE, which are in the OCI, be classified when an entity transfers a group of insurance contracts or derecognises an insurance contract under paragraph 91?

For all contracts except those with direct participation features (VFA contracts), the entity will reclassify any previously recognised OCI to P&L as a reclassification adjustment.

For contracts with direct participation features (VFA contracts), it will not reclassify any previously recognised OCI to P&L as a reclassification adjustment.

For disclosure requirements related to the disaggregation of IFIE between P&L and OCI, see questions 17.17-17.19.

16.11 How should an entity treat exchange differences on changes in the carrying amount of groups of insurance contracts?

The entity should include exchange differences on changes in the carrying amount of groups of insurance contracts in the P&L, unless they relate to changes in the carrying amount included in OCI, in which case they should be included in OCI (paragraph 92).

An example is as follows:

Finance income (expenses) from insurance contracts issued								
Changes in fair value of underlying assets of contracts measured under the VFA	-	-	(2,622)	-	-	-	-	(2,622)
Interest accreted	(3,265)	(2,380)	(34)	(506)	-	(503)	-	(6,688)
Effect of changes in interest rates and other financial assumptions	827	464	2	100	-	15	-	1,408
Effect of changes in FCF at current rates when CSM is unlocked at locked-in rates	4	6	-	(2)	-	-	-	8
Foreign exchange differences	-	-	-	209	-	-	-	209
Finance expenses from insurance contracts issued	**(2,434)**	**(1,910)**	**(2,654)**	**(199)**	**-**	**(486)**	**-**	**(7,665)**
Finance income (expenses) from reinsurance contracts held								
Interest accreted	2,218	-	-	-	-	11	-	2,229
Effect of changes in interest rates and other financial assumptions	(616)	-	-	-	-	-	-	(616)
Effect of changes in FCF at current rates when CSM is unlocked at locked-in rates	(3)	-	-	-	-	-	-	(3)
Finance income from reinsurance contracts held	**1,599**	**-**	**-**	**-**	**-**	**11**	**-**	**1,610**
Net insurance finance expenses	**(835)**	**(1,910)**	**(2,654)**	**(199)**	**-**	**(477)**	**-**	**(6,075)**

Source: PWC's Illustrative Financial Statements

Chapter 17 – Disclosure Requirements Under IFRS 17 – Insurance Contracts

17.1 What are the key areas of disclosure required under IFRS 17?

Paragraph 93 states that an entity shall disclose qualitative and quantitative information about:

a) *the amounts recognised in its financial statements for contracts within the scope of IFRS 17 (see paragraphs 97-116);*

b) *the significant judgements, and changes in those judgements, made when applying IFRS 17 (see paragraphs 117-120); and*

c) *the nature and extent of the risks from contracts within the scope of IFRS 17 (see paragraphs 121-132).*

The table below summarise the disclosure requirements under IFRS 17 as issued by the IASB according to these areas.

Areas required for disclosure	**Item**	**IFRS 17 Reference**	**IAN 100 Reference**
(a) Explanation of recognised amounts	General requirements	Paragraphs 97 – 99	17.2
	Specific requirements under PAA		17.8
	Specific requirements under other measurement methods (non PAA)	Paragraphs 100 – 109	17.6
	IFIE disclosures	Paragraphs 110 - 113	17.14
(b) Significant judgements	Inputs, assumptions and estimation techniques	Paragraph 117	17.16
	Disaggregation of IFIE	Paragraph 118	17.14
	Risk adjustment for non-financial risk	Paragraph 119	17.16
	Yield Curve used to discount cashflows	Paragraph 120	17.16, 17.22
(c) Nature and extent of the risks	General requirements	Paragraphs 121 – 126	17.23, 17.24
	Concentration risk	Paragraph 127	17.23, 17.24

	Insurance and market risks – Sensitivities	Paragraphs 128 - 129	17.23, 17.24
	Insurance risks - claims development	Paragraph 130	17.23, 17.24
	Credit risk	Paragraph 131	17.23, 17.24
	Liquidity risk	Paragraph 132	17.23, 17.24
(d) Transition arrangements	Transition Amounts	Paragraphs 114 - 116	17.15

17.2 How should information be aggregated for disclosure?

Information should be aggregated or disaggregated such that useful information is not obscured either by the inclusion of a large amount of insignificant detail or by the aggregation of items that have different characteristics.

Examples of aggregation bases that might be appropriate for information disclosed about insurance contracts are:

a. type of contract (for example, major product lines); or

b. geographical area (for example, country or region).

Explanation of recognised amounts

17.3 What is the objective of the reconciliation between opening and closing balance of the insurance contract liabilities?

The objective is to provide different types of information about the insurance result.

Providing a reconciliation allows users to understand how the insurance contract liabilities changed during the period because of cash flows and income and expenses recognised in the statement of financial performance.

17.4 How many reconciliations are required and how much detail is required in the reconciliation of the change in insurance contract liabilities during the period?

The specific reconciliations required for disclosure vary according to the measurement approach adopted.

- Under all measurement approaches, an entity shall disclose reconciliations showing separately liabilities arising from claims already incurred and net liabilities for the remaining coverage component. Refer to question 17.6 and 17.7 for further detail.
- For measurement approaches for where the PAA has not been applied, an entity shall additionally disclose reconciliations for each component under the GMA. Refer to question 17.8 for further detail.

17.5 How should the reconciliation of the change in insurance contract liabilities be broken down? Which line items should be in the reconciliation?

Reconciliations should be split by:

a. Net liabilities for the remaining coverage component (excluding any loss component);

b. loss components; and

c. the liabilities for incurred claims.

Reconciliations should include the following line items:

a. insurance revenue;

b. insurance service expenses, showing separately:

   i. incurred claims and other incurred insurance service expenses;

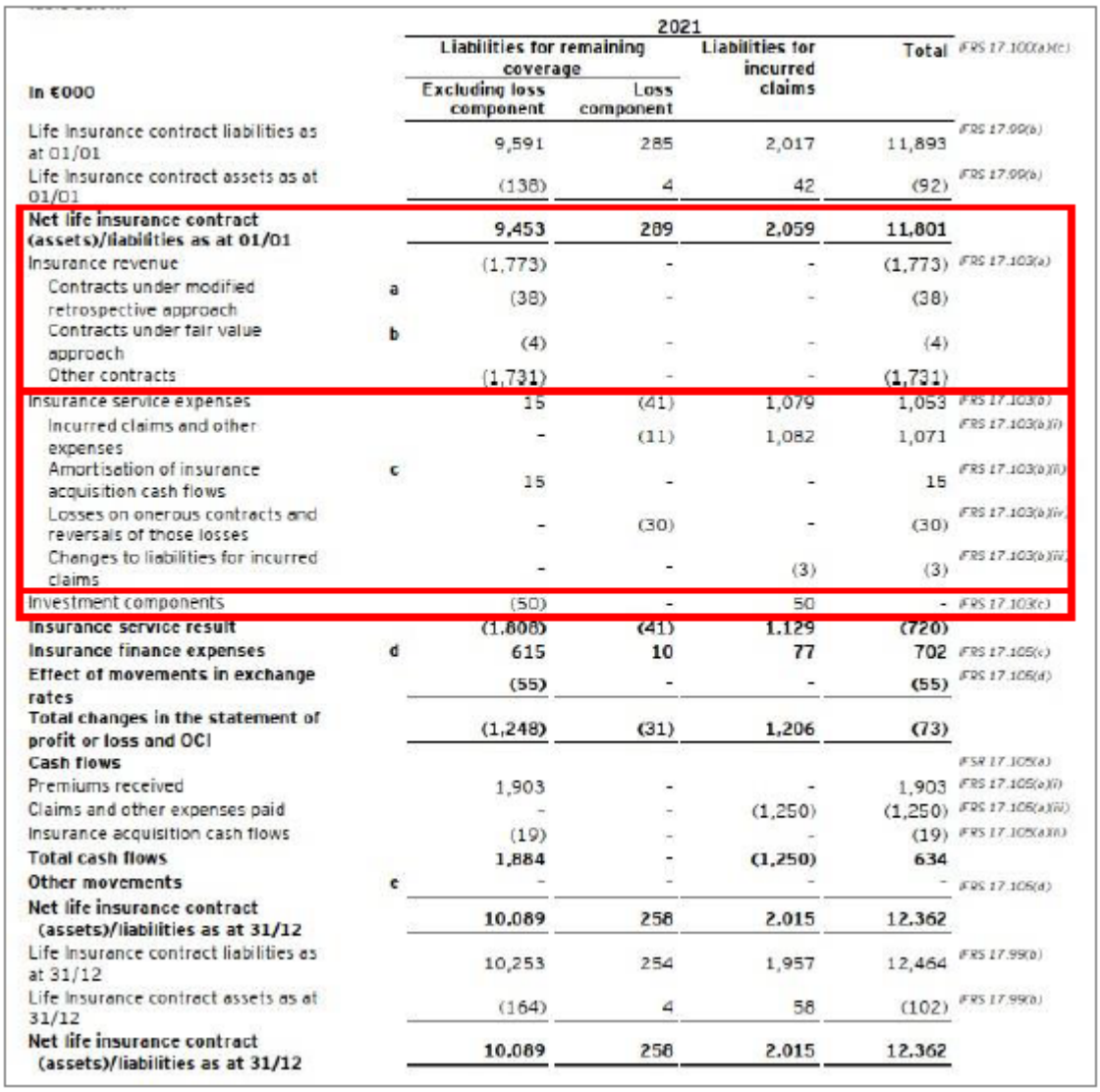
   ii. amortisation of insurance acquisition cash flows;

   iii. changes that relate to past service; and

   iv. changes that relate to future service.

c. c. investment components (including refunds of premiums) excluded from insurance revenue and insurance service expenses.

An example is as follows:



In €000		2021 Liabilities for remaining coverage: Excluding loss component	Liabilities for remaining coverage: Loss component	Liabilities for incurred claims	Total	IFRS 17.100(a)(c)
Life insurance contract liabilities as at 01/01		9,591	285	2,017	11,893	IFRS 17.99(b)
Life insurance contract assets as at 01/01		(138)	4	42	(92)	IFRS 17.99(b)
Net life insurance contract (assets)/liabilities as at 01/01		**9,453**	**289**	**2,059**	**11,801**	
Insurance revenue		(1,773)	-	-	(1,773)	IFRS 17.103(a)
Contracts under modified retrospective approach	a	(38)	-	-	(38)	
Contracts under fair value approach	b	(4)	-	-	(4)	
Other contracts		(1,731)	-	-	(1,731)	
Insurance service expenses		15	(41)	1,079	1,053	IFRS 17.103(b)
Incurred claims and other expenses		-	(11)	1,082	1,071	IFRS 17.103(b)(i)
Amortisation of insurance acquisition cash flows	c	15	-	-	15	IFRS 17.103(b)(ii)
Losses on onerous contracts and reversals of those losses		-	(30)	-	(30)	IFRS 17.103(b)(iv)
Changes to liabilities for incurred claims		-	-	(3)	(3)	IFRS 17.103(b)(iii)
Investment components		(50)	-	50	-	IFRS 17.103(c)
Insurance service result		**(1,808)**	**(41)**	**1,129**	**(720)**	
Insurance finance expenses	d	**615**	**10**	**77**	**702**	IFRS 17.105(c)
Effect of movements in exchange rates		**(55)**	-	-	**(55)**	IFRS 17.105(d)
Total changes in the statement of profit or loss and OCI		**(1,248)**	**(31)**	**1,206**	**(73)**	
Cash flows						IFRS 17.105(a)
Premiums received		1,903	-	-	1,903	IFRS 17.105(a)(i)
Claims and other expenses paid		-	-	(1,250)	(1,250)	IFRS 17.105(a)(iii)
Insurance acquisition cash flows		(19)	-	-	(19)	IFRS 17.105(a)(ii)
Total cash flows		**1,884**	-	**(1,250)**	**634**	
Other movements	e	-	-	-	-	IFRS 17.105(d)
Net life insurance contract (assets)/liabilities as at 31/12		**10,089**	**258**	**2,015**	**12,362**	
Life insurance contract liabilities as at 31/12		10,253	254	1,957	12,464	IFRS 17.99(b)
Life insurance contract assets as at 31/12		(164)	4	58	(102)	IFRS 17.99(b)
Net life insurance contract (assets)/liabilities as at 31/12		**10,089**	**258**	**2,015**	**12,362**	

Source: EY's Illustrative Financial Statements

17.6 When the PAA has not been applied, how are the additional reconciliations of the change in insurance contract liabilities presented?

For insurance contracts other than those to which the PAA has been applied, an entity should split the reconciliation of opening to closing balances by:

a. the estimates of the present value of future cash flows

b. risk adjustment for non-financial risk

c. CSM

Reconciliations should include the following line items:

a. changes that relate to future service showing separately:

   i. changes in estimates that adjust the CSM;

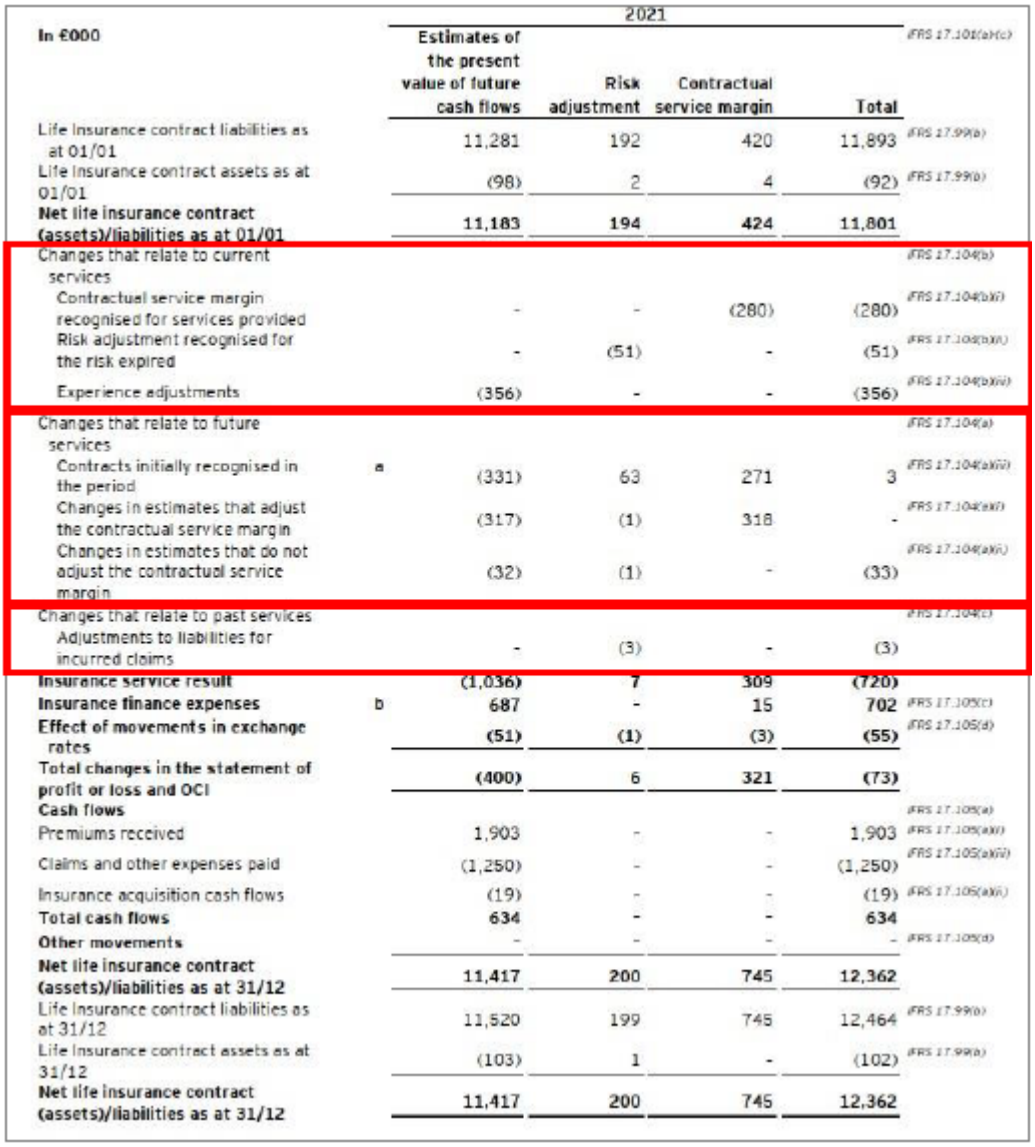
ii. changes in estimates that do not adjust the CSM, i.e., losses on groups of onerous contracts and reversals of such losses; and

iii. the effects of contracts initially recognised in the period.

b. changes that relate to current service; and

c. changes that relate to past service.

An example is as follows:



In €000		2021 Estimates of the present value of future cash flows	Risk adjustment	Contractual service margin	Total	
Life insurance contract liabilities as at 01/01		11,281	192	420	11,893	IFRS 17.99(b)
Life insurance contract assets as at 01/01		(98)	2	4	(92)	IFRS 17.99(b)
Net life insurance contract (assets)/liabilities as at 01/01		**11,183**	**194**	**424**	**11,801**	
Changes that relate to current services						IFRS 17.104(b)
Contractual service margin recognised for services provided		-	-	(280)	(280)	IFRS 17.104(b)(ii)
Risk adjustment recognised for the risk expired		-	(51)	-	(51)	IFRS 17.104(b)(ii)
Experience adjustments		(356)	-	-	(356)	IFRS 17.104(b)(iv)
Changes that relate to future services						IFRS 17.104(a)
Contracts initially recognised in the period	a	(331)	63	271	3	IFRS 17.104(a)(iii)
Changes in estimates that adjust the contractual service margin		(317)	(1)	318	-	IFRS 17.104(a)(i)
Changes in estimates that do not adjust the contractual service margin		(32)	(1)	-	(33)	IFRS 17.104(a)(ii)
Changes that relate to past services						IFRS 17.104(c)
Adjustments to liabilities for incurred claims		-	(3)	-	(3)	
Insurance service result		**(1,036)**	**7**	**309**	**(720)**	
Insurance finance expenses	b	**687**	**-**	**15**	**702**	IFRS 17.105(c)
Effect of movements in exchange rates		**(51)**	**(1)**	**(3)**	**(55)**	IFRS 17.105(d)
Total changes in the statement of profit or loss and OCI		**(400)**	**6**	**321**	**(73)**	
Cash flows						IFRS 17.105(a)
Premiums received		1,903	-	-	1,903	IFRS 17.105(a)(i)
Claims and other expenses paid		(1,250)	-	-	(1,250)	IFRS 17.105(a)(ii)
Insurance acquisition cash flows		(19)	-	-	(19)	IFRS 17.105(a)(i)
Total cash flows		**634**	**-**	**-**	**634**	
Other movements		-	-	-	-	IFRS 17.105(b)
Net life insurance contract (assets)/liabilities as at 31/12		**11,417**	**200**	**745**	**12,362**	
Life insurance contract liabilities as at 31/12		11,520	199	745	12,464	IFRS 17.99(b)
Life insurance contract assets as at 31/12		(103)	1	-	(102)	IFRS 17.99(b)
Net life insurance contract (assets)/liabilities as at 31/12		**11,417**	**200**	**745**	**12,362**	

Source: EY's Illustrative Financial Statements

17.7 What else should be shown to complete these reconciliations of the change in insurance contract liabilities?

The reconciliations should also disclose:

a. cash flows in the period, including premiums received, incurred claims and other insurance service expenses paid and insurance acquisition cash flows;

b. the effect of changes in the risk of non-performance by the issuer of reinsurance contracts held;

c. insurance finance income or expenses; and

d. any additional line items that may be necessary to understand the change in the net carrying amount of the insurance contracts.

17.8 If the entity uses the PAA, what does it need to disclose?

It must disclose in the financial statements:

a. which of the criteria in premium allocation approach it has satisfied;

b. whether it makes an adjustment for the time value of money and the effect of financial risk

c. the method it has chosen to recognise insurance acquisition cash flows.

Some of the requirements to disclose reconciliations (paragraphs 98-105) are amended or not applied when using the PAA.

An example is as follows:

IFRS 17.97(a), [IFRS 17.53, 69]	***vi. Measurement – Contracts measured under the PAA*** In the non-life segment, the Group generally uses the PAA to simplify the measurement of groups of contracts on the following bases: – *insurance contracts:* the coverage period of each contract in the group of contracts is one year or less; and – *reinsurance contracts:* the Group reasonably expects that the resulting measurement would not differ materially from the result of applying the accounting policies in (v). However, certain groups of insurance contracts are acquired in their claims settlement period. The claims from some of these groups are expected to develop over more than one year. The Group measures these groups under the accounting policies in (v).
IFRS 17.97(c), [IFRS 17.55(a), 59(a)]	On initial recognition of each group of contracts, the carrying amount of the liability for remaining coverage is measured at the premiums received on initial recognition. Insurance acquisition cash flows are recognised as expenses when they are incurred.[a]
IFRS 17.97(b), [IFRS 17.55(b)–56]	Subsequently, the carrying amount of the liability for remaining coverage is increased by any premiums received and decreased by the amount recognised as insurance revenue for coverage provided (see (viii)). On initial recognition of each group of contracts, the Group expects that the time between providing each part of the coverage and the related premium due date is no more than a year. Accordingly, the Group has chosen not to adjust the liability for remaining coverage to reflect the time value of money and the effect of financial risk.
IFRS 17.97(b), [IFRS 17.57–58]	If at any time during the coverage period, facts and circumstances indicate that a group of contracts is onerous, then the Group recognises a loss in profit or loss and increases the liability for remaining coverage to the extent that the current estimates of the fulfilment cash flows that relate to remaining coverage (including the risk adjustment for non-financial risk) exceed the carrying amount of the liability for remaining coverage. The fulfilment cash flows are adjusted for the time value of money and the effect of financial risk (using current estimates) if the liability for incurred claims is also adjusted for the time value of money and the effect of financial risk (see below).
IFRS 17.97(b), [IFRS 17.59(b), B72(a)]	The Group recognises the liability for incurred claims of a group of insurance contracts at the amount of the fulfilment cash flows relating to incurred claims. The fulfilment cash flows are discounted (at current rates) unless the cash flows are expected to be paid in one year or less from the date the claims are incurred.

Source: KPMG's Illustrative Financial Statements

17.9 Are there any differences with respect to presentation for Direct Participating Contracts ("DPCs")?

There are no specific presentation requirements for DPCs.

17.10 Are there any additional disclosures required for DPCs?

Paragraphs 110-113 set out additional requirements for DPCs.

An entity is required to explain the relationship between IFIE and the investment return on its assets (paragraph 110).

- The composition of the underlying items and their fair value is also disclosed (paragraph 111).
- If risk mitigation is used and the CSM is not adjusted for some changes in the fulfilment cashflows the impact of this on the CSM is disclosed (paragraph112).

- If the basis for disaggregation of IFIE is changed then the period when the change occurred, the reason, any adjustments as a result and the carrying amount of the contracts to which the change applied are disclosed (paragraph 113).

17.11 Are reconciliations for reinsurance contracts held shown separately?

Yes, paragraph 98 specifies that separate reconciliations shall be disclosed for insurance contracts issued and reinsurance contracts held and that the reconciliations should be adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued.

17.12 Are any disclosures required specifically for insurance issued and reinsurance contracts issued and held in the current period?

Yes, for insurance contracts other than those where the PAA has been applied, their effect on insurance contract liabilities at initial recognition must be shown:

a. the estimates of the present value of future cash outflows, showing separately the amount of the insurance acquisition cash flows;

b. the estimates of the present value of future cash inflows;

c. the risk adjustment for non-financial risk; and

d. the CSM.

One must also separately disclose amounts resulting from:

a. contracts acquired from other entities in transfers of insurance contracts or business combinations; and

b. groups of contracts that are onerous,

as well as separately for insurance contracts issued and reinsurance contracts held.

An example is as follows:

IFRS 17|108| Life Risk - Insurance contracts issued	20X4 Non-onerous contracts originated	20X4 Onerous contracts originated	20X4 Total	20X3 Non-onerous contracts originated	20X3 Onerous contracts originated	20X3 Total
IFRS 17|107|(a)	Estimates of the present value of future cash outflows						
IFRS 17|107|(a)	- Insurance acquisition cash flows	5,942	281	6,223	4,753	225	4,978
IFRS 17|107|(a)	- Claims and other directly attributable expenses	152,932	7,648	160,580	123,173	6,159	129,332
	Estimates of the present value of future cash outflows	158,874	7,929	166,803	127,926	6,384	134,310
IFRS 17|107|(b)	Estimates of the present value of future cash inflows	(183,465)	(8,703)	(192,168)	(147,502)	(6,997)	(154,499)
IFRS 17|107|(c)	Risk adjustment for non-financial risk	16,180	809	16,989	13,031	652	13,683
IFRS 17|107|(d)	CSM	8,411	-	8,411	6,545	-	6,545
	Increase in insurance contract liabilities from contracts recognised in the period	**-**	**35**	**35**	**-**	**39**	**39**

Source: PWC's Illustrative Financial Statements

17.13 How is the CSM release pattern disclosed?

Apart from contracts where the PAA has been applied, IFRS 17 requires an entity to disclose when they expect to recognise the CSM remaining at the end of the reporting period in P&L quantitatively, in appropriate time bands.

This information should be provided separately for insurance contracts issued and reinsurance contracts held.

An example is as follows:

12.3. CSM recognition in profit or loss

The disclosure of when the CSM is expected to be in income in future years is presented below:

	2021						
In €000	**Less than 1 year**	**1-2 years**	**2-3 years**	**3-4 years**	**4-5 years**	**More than 5 years**	**Total**
Insurance contracts issued							
Life insurance unit	34	39	50	103	95	424	745
Life reinsurance unit	34	36	49	58	62	92	331
	68	**75**	**99**	**161**	**157**	**516**	**1,076**
Reinsurance contracts held							
Life insurance unit	23	17	-	44	32	45	161
	23	**17**	**-**	**44**	**32**	**45**	**161**

	2020						
In €000	**Less than 1 year**	**1-2 years**	**2-3 years**	**3-4 years**	**4-5 years**	**More than 5 years**	**Total**
Insurance contracts issued							
Life insurance unit	28	22	34	31	64	245	424
Life reinsurance unit	19	16	22	22	26	51	156
	47	**38**	**56**	**53**	**90**	**296**	**580**
Reinsurance contracts held							
Life insurance unit	3	3	3	-	6	9	24
	3	**3**	**3**	**-**	**6**	**9**	**24**

Source: EY's Illustrative Financial Statements

17.14 To what degree do the underlying items summing up to the IFIE need to be explained?

The disclosure for IFIE must explain the relationship between IFIE and the investment return on its assets, to enable users of its financial statements to evaluate the sources of finance income or expenses recognised in P&L and OCI.

An example is as follows:

In €000	2021 Insurance related: Life contracts	Insurance related: Reinsurance contracts issued	Non-insurance related	Total
Insurance finance income / (expenses) from insurance contracts issued				
Interest accreted to insurance contracts using current financial assumptions	-	(289)	-	(289)
Interest accreted to insurance contracts using locked-in rate	(507)	-	-	(507)
Due to changes in interest rates and other financial assumptions	(195)	-	-	(195)
Net foreign exchange income / (expense)	55	-	-	55
Total insurance finance income / (expenses) from insurance contracts issued	**(647)**	**(289)**	**-**	**(936)**
Represented by:				
Amounts recognised in profit or loss	(453)	(289)	-	(742)
Amounts recognised in OCI	(194)	-	-	(194)

Source: EY's Illustrative Financial Statements

17.15 Are there any changes to the presentation or disclosure requirements when applying IFRS 17 for the first time?

Paragraphs C25 – C28 specify exceptions to the presentation of comparative information when applying IFRS 17 for the first time. These are summarised below.

- Comparative information for periods earlier than the beginning of the annual reporting period immediately preceding the date of initial application may be included but is not required.
- Disclosures specified in paragraphs 93 – 132 are not required for comparative periods before the beginning of the annual reporting period immediately preceding the date of initial application.
- If unadjusted comparative information and disclosures are presented for earlier periods, it must be disclosed that the information has not been adjusted and explain the basis on which it has been prepared.
- Previously unpublished information about claims development that occurred earlier than five years prior to transition to IFRS 17 need not be disclosed. However, if an entity does not disclose that information, it shall disclose that fact.

If an entity redesignates financial assets under IFRS 9 in accordance with paragraph C29 then additional disclosures must be made in accordance with paragraphs C32 and C33.

Significant judgements in applying IFRS 17

17.16 What are the minimum disclosure requirements made in applying IFRS 17?

The minimum disclosure requirements in applying IFRS 17 include specific requirements around inputs, assumptions and estimation techniques. In particular, these include:

a. the methods used to measure insurance contracts and the processes for estimating the inputs to those methods, including quantitative information about those inputs; and

b. any changes in the methods and processes for estimating inputs used to measure contracts, the reason for each change, and the type of contracts affected.

Additionally, there are specific requirements to disclose the approach used, as set out in paragraph 117, to:

i. distinguish changes in estimates of future cash flows arising from the exercise of discretion from other changes in estimates of future cash flows for contracts without direct participation features;

ii. determine the risk adjustment for non-financial risk, including the confidence level or equivalent confidence level (if a different technique is used to determine the risk adjustment);

iii. determine discount rates, including the yield curve/s used to discount cash flows that do not vary based on the returns on underlying items;

iv. determine investment components; and

v. determine the relative weighting of benefits provided by insurance coverage and investment-return service (for insurance contracts without direct participation features) or insurance coverage and investment-related service (for insurance contracts with direct participation features).

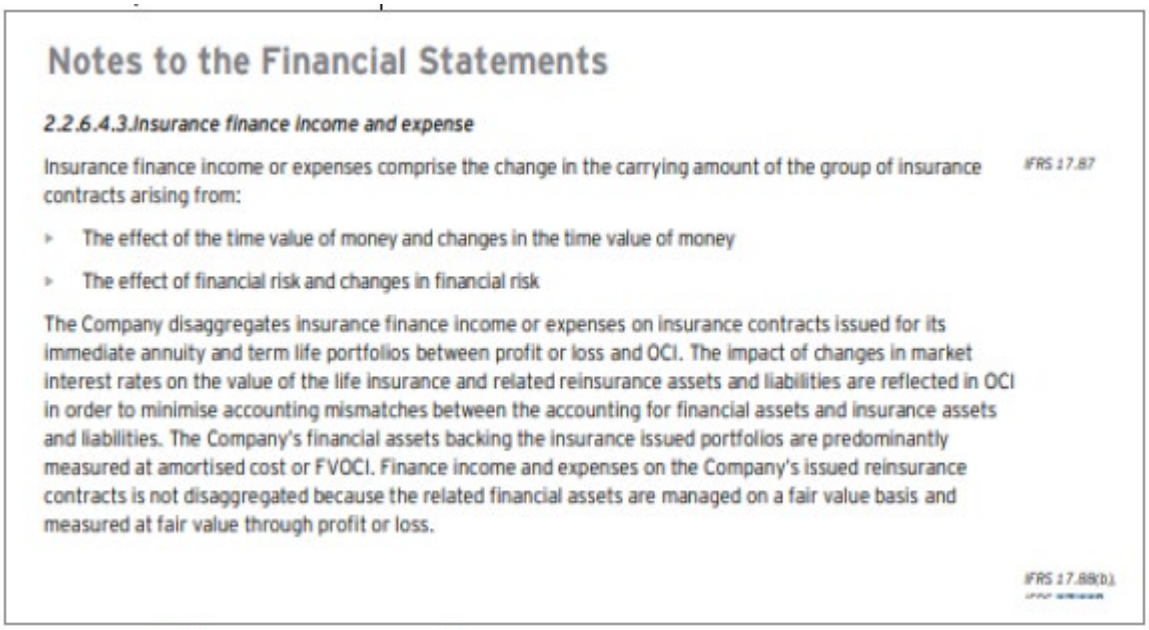
17.17 Are there any disclosure requirements if an entity elects to disaggregate IFIE into amounts presented in P&L, and amounts presented in OCI?

Yes, the entity shall disclose an explanation of the methods used to determine the IFIE recognised in P&L.

17.18 If IFIE is disaggregated, what disclosure requirements must the entity observe?

Paragraph 112 requires that the entity discloses an explanation of the methods used to determine the IFIE recognised in P&L.

An example is as follows:



Notes to the Financial Statements

2.2.6.4.3.Insurance finance income and expense

Insurance finance income or expenses comprise the change in the carrying amount of the group of insurance contracts arising from: IFRS 17.87

- The effect of the time value of money and changes in the time value of money
- The effect of financial risk and changes in financial risk

The Company disaggregates insurance finance income or expenses on insurance contracts issued for its immediate annuity and term life portfolios between profit or loss and OCI. The impact of changes in market interest rates on the value of the life insurance and related reinsurance assets and liabilities are reflected in OCI in order to minimise accounting mismatches between the accounting for financial assets and insurance assets and liabilities. The Company's financial assets backing the insurance issued portfolios are predominantly measured at amortised cost or FVOCI. Finance income and expenses on the Company's issued reinsurance contracts is not disaggregated because the related financial assets are managed on a fair value basis and measured at fair value through profit or loss.

IFRS 17.88(b)

Source: EY's Illustrative Financial Statements

17.19 For contracts with direct participation features (VFA contracts), if an entity changes the disaggregation basis of IFIE between P&L and OCI, what disclosure requirements must it observe?

Paragraph 113 requires that the entity discloses in the period when the change occurred:

a. the reason why the entity was required to change the basis of disaggregation;

b. the amount of any adjustment for each financial statement line item affected; and

c. the carrying amount of the group of insurance contracts to which the change applied at the date of the change.

17.20 What are the disclosure requirements for describing the components of contracts with direct participation features (VFA contracts)?

For contracts with direct participation features, the entity shall describe the composition of the underlying items and disclose their fair value (see paragraph 111).

See example below:

Underlying items

The following table sets out the composition and the fair value of underlying items of the Group's participating contracts at the reporting date.[a]

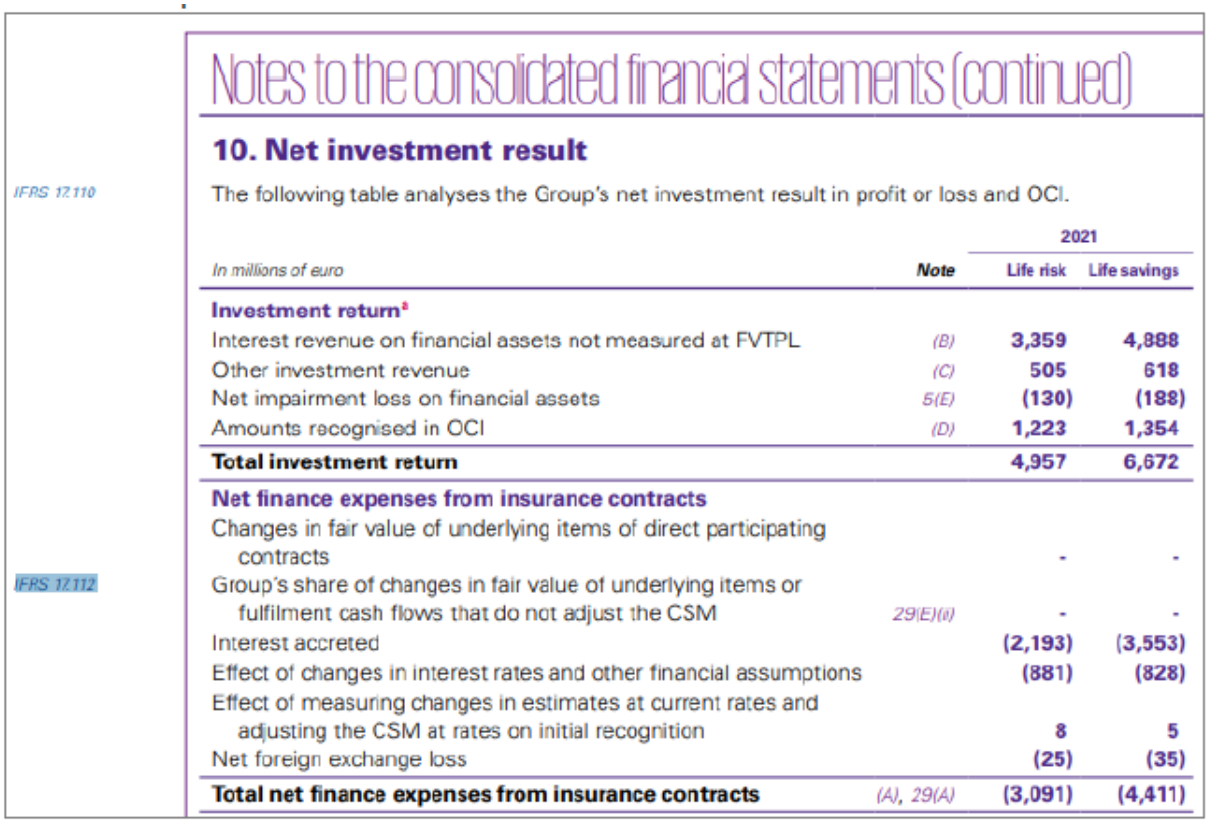
		31 December 2021			31 December 2020 (restated)		
In millions of euro	**Note**	**Direct participating contracts**	**Investment contracts and consolidated funds**	**Total**	**Direct participating contracts**	**Investment contracts and consolidated funds**	**Total**
Cash and cash equivalents	*19*	**6,704**	**261**	**6,965**	6,195	545	6,740
Financial investments	*20*	**187,306**	**24,517**	**211,823**	176,324	22,264	198,588
Receivables	*21*	**16**	**2**	**18**	25	3	28
Investment property	*22*	**5,177**	**693**	**5,870**	5,164	665	5,829
Owner-occupied property	*24(A)*	**492**	**-**	**492**	399	-	399
Derivative liabilities	*20(A)*	**(718)**	**(28)**	**(746)**	(661)	(27)	(688)
		198,977	**25,445**	**224,422**	187,446	23,450	210,896

Source: KPMG's Illustrative Financial Statements

17.21 What are the disclosure requirements for contracts with direct participation features (VFA contracts), if an entity chooses not to adjust the CSM for some changes in the fulfilment cash flows? (Paragraph 112)

Paragraph 112 requires that the entity discloses the effect of that choice on the adjustment to the contract service margin in the current period.

See an example below:



Notes to the consolidated financial statements (continued)

10. Net investment result

IFRS 17.110 The following table analyses the Group's net investment result in profit or loss and OCI.

In millions of euro	Note	2021 Life risk	2021 Life savings
Investment return[a]			
Interest revenue on financial assets not measured at FVTPL	(B)	3,359	4,888
Other investment revenue	(C)	505	618
Net impairment loss on financial assets	5(E)	(130)	(188)
Amounts recognised in OCI	(D)	1,223	1,354
Total investment return		4,957	6,672
Net finance expenses from insurance contracts			
Changes in fair value of underlying items of direct participating contracts		-	-
IFRS 17.112 Group's share of changes in fair value of underlying items or fulfilment cash flows that do not adjust the CSM	29(E)(ii)	-	-
Interest accreted		(2,193)	(3,553)
Effect of changes in interest rates and other financial assumptions		(881)	(828)
Effect of measuring changes in estimates at current rates and adjusting the CSM at rates on initial recognition		8	5
Net foreign exchange loss		(25)	(35)
Total net finance expenses from insurance contracts	(A), 29(A)	(3,091)	(4,411)

Source: KMPG's Illustrative Financial Statements

17.22 Are there any disclosure requirements related to the yield curve (or range of yield curves) used to discount cash flows that do not vary based on the returns on underlying items?

Yes, when an entity provides this disclosure in aggregate for a number of groups of insurance contracts, the entity shall provide such disclosures in the form of weighted averages, or relatively narrow ranges.

An example is as follows:

IFRS 17(120)

Product	Currency	20X4 1 year	20X4 5 years	20X4 10 years	20X4 20 years	20X4 30 years	20X3 1 year	20X3 5 years	20X3 10 years	20X3 20 years	20X3 30 years
Life Risk (issued and reinsurance held)	CU	3.02%	3.97%	4.56%	4.76%	5.25%	3.08%	4.03%	4.62%	4.82%	5.31%
Savings	CU	2.77%	3.52%	4.21%	4.43%	4.85%	2.82%	3.57%	4.26%	4.48%	4.90%
Participating											
- Direct participating contracts	CU	2.42%	3.37%	3.96%	-	-	2.46%	3.41%	4.00%	-	-
- Investment contracts with DPF	FU	2.02%	2.97%	3.56%	-	-	2.06%	3.01%	3.60%	-	-
Property and Casualty (issued and reinsurance held)	CU	3.02%	3.97%	4.56%	-	-	3.08%	4.03%	4.62%	-	-

Source: PWC's Illustrative Financial Statements

Nature and extent of risks that arise from contracts within the scope of IFRS 17

17.23 What are the minimum disclosure requirements in regard to the nature and extent of risks that arise from contracts within the scope of IFRS 17?

IFRS17 requires entities to disclose information that enables users of its financial statements to evaluate the nature, amount, timing and uncertainty of future cash flows from contracts within the scope of IFRS 17. The risks typically expected to arise are insurance risk and financial risks (including credit risk, liquidity risk and market risk).

If the entity's exposure at the end of the reporting period is not representative of its exposure to risk during the period, further information will need to be disclosed around the true risk exposure during this period and why these differences have occurred.

17.24 What information must be disclosed around the risks arising from contracts?

For each type of risk arising from contracts, entities must disclose:

a. the exposures to risks and how they arise;

The Company offers term life and immediate annuity contracts, as well as life reinsurance contracts.

The main risks that the Company is exposed to are, as follows:

- Mortality risk – risk of loss arising due to the incidence of policyholder death being different than expected
- Morbidity risk – risk of loss arising due to policyholder health experience being different than expected
- Longevity risk – risk of loss arising due to the annuitant living longer than expected
- Expense risk – risk of loss arising from expense experience being different than expected
- Policyholder decision risk – risk of loss arising due to policyholder experiences (lapses and surrenders) being different than expected

Source: EY's Illustrative Financial Statements

b. the entity's objectives, policies and processes for managing the risks and the methods used to measure the risks. An example is below:

The objective of the Company is to ensure that sufficient reserves are available to cover the liabilities associated with the insurance and reinsurance contracts that it issues. The risk exposure is mitigated by diversification across the portfolios of insurance contracts. The variability of risks is also improved by careful selection and implementation of underwriting strategy guidelines, as well as the use of outwards reinsurance arrangements.

Source: EY's Illustrative Financial Statements

c. any changes in (a) or (b) from the previous period. An example is below:

The nature of the Company's exposure to insurance risks and its objectives, policies and processes used to manage and measure the risks have not changed from the previous period.

Source: EY's Illustrative Financial Statements

In addition to the above disclosures required by paragraph 124, paragraph 125 also requires quantitative information on risk exposures to be disclosed.

The nature of the Company's exposure to insurance risks and its objectives, policies and processes used to manage and measure the risks have not changed from the previous period.

The geographical concentration of the Company's life insurance and reinsurance issued (both before and after reinsurance) contracts is shown below. The disclosure is based on the countries where the business is written.

	2021			2020		
In €000	**Insurance and reinsurance issued**	**Reinsurance held**	**Net**	**Insurance and reinsurance issued**	**Reinsurance held**	**Net**
Direct life insurance contracts issued	7,391	(1,649)	5,741	6,683	(1,562)	5,121
Euroland						
United States	645	(174)	471	988	(247)	741
Total term life contracts	**8,036**	**(1,823)**	**6,212**	**7,671**	**(1,809)**	**5,862**
Euroland	3,980	(888)	3,092	3,598	(841)	2,757
United States	347	(94)	254	532	(133)	399
Total immediate annuity contracts	**4,327**	**(982)**	**3,346**	**4,130**	**(974)**	**3,156**
Total life insurance	**12,363**	**(2,805)**	**9,558**	**11,801**	**(2,783)**	**9,018**

Source: EY's Illustrative Financial Statements

17.25 What regulatory information must be disclosed under IFRS 17?

Information about the effect of the regulatory frameworks in which the entity operates must be disclosed.

This may include minimum capital requirements or required interest-rate guarantees. If contracts are included in the same group based on the existence of legal or regulatory constraints on prices or levels or benefits (paragraph 20 of IFRS 17), this must also be disclosed.

An example is as follows:

The table below summarises the minimum required capital for the Group and the regulatory capital held. The current year is, in general, an estimate that is updated once calculations prepared for the regulators are final.

	20X4	20X3
Regulatory capital held	141%	139%
Minimum regulatory capital	58,100	50,500

In Oneland, the solvency and capital adequacy margins are calculated based on Oneland Solvency Law, which requires the application of a formula that contains variables for expenses, inflation, investment earnings, death, disability claims, surrenders, policyholder options, distribution of assets among investment classes and the matching of specific classes of assets and liabilities.

The Group is subject to a 20X2 Oneland law requiring insurance groups to calculate a consolidated solvency margin. The Group must establish appropriate internal controls to ensure solvency sufficient to cover all of the Group's insurance liabilities, to inform Oneland's insurance regulatory authorities annually of certain intra-Group transactions and to calculate on a consolidated basis the capital needed to meet the respective solvency requirements of the Group's insurance subsidiaries.

During the period, the Group was compliant with the externally imposed capital requirements.

Source: PWC's Illustrative Financial Statements

17.26 What risks should be addressed in the disclosures under IFRS 17?

Under IFRS 17, the following risks should be addressed:

a. concentrations of risk;

b. insurance and market risks;

c. insurance risk - claims development;

d. credit risk; and

e. liquidity risk.

17.27 What information about concentration risk must be disclosed?

The following must be disclosed about concentration risk:

i. how the concentrations are determined; and

ii. shared characteristics that identifies each concentration (e.g., the type of insured event, industry, geographical area or currency).

For example, concentrations of financial risk might arise from interest-rate guarantees that come into effect at the same level for a large number of contracts.

Concentrations of financial risk might also arise from concentrations of non-financial risk. For example, if an entity provides product liability protection to pharmaceutical companies and also holds investments in those companies.

17.28 What information about sensitivities to changes in risk variables must be disclosed?

Paragraph 128 requires the following disclosures to be made around sensitivities to changes in risk variables:

a. *a sensitivity analysis that shows how profit or loss and equity would have been affected by changes in risk variables that were reasonably possible at the end of the reporting period:*

b. *for insurance risk - showing the effect for insurance contracts issued, before and after risk mitigation by reinsurance contracts held; and*

c. *for each type of market risk - in a way that explains the relationship between the sensitivities to changes in risk variables arising from insurance contracts and those arising from financial assets held by the entity.*

a. *the methods and assumptions used in preparing the sensitivity analysis; and*

b. *changes from the previous period in the methods and assumptions used in preparing the sensitivity analysis, and the reasons for such changes.*

If instead a sensitivity analysis showing how amounts different from those specified above (i.e., P&L and equity) are affected by changes in risk variables, and is used to manage risks arising from contracts within the scope of IFRS 17, it may use that sensitivity analysis in place of the analysis specified above. Paragraph 129 requires that the following be disclosed:

a. *an explanation of the method used in preparing such a sensitivity analysis and of the main parameters and assumptions underlying the information provided; and*

b. *an explanation of the objective of the method used and of any limitations that may result in the information provided.*

17.29 What information about claims development must be disclosed?

IFRS 17 requires the disclosure of actual claims compared with previous estimates of the undiscounted amount of the claims (paragraph 130).

The disclosure is required to start at the period when the earliest material claim(s) arose and for which there is still uncertainty about the amount and timing of the claim payments at the end of the reporting period, limited to 10 years prior to the end of the reporting period.

An entity is not required to disclose information about the development of claims for which uncertainty about the amount and timing of the claims payments is typically resolved within one year.

17.30 What information about credit risk must be disclosed?

Paragraph 131 requires the following disclosures around credit risk:

a. *the amount that best represents its maximum exposure to credit risk at the end of the reporting period, separately for insurance contracts issued and reinsurance contracts held; and*

b. *information about the credit quality of reinsurance contracts held that are assets*

An example is as follows:

Credit exposure by credit rating

The table below provides information regarding the credit risk exposure of the company by classifying assets according to the Company's credit ratings of counterparties.

	2021				
In €000	**High grade**	**Standard grade**	**Past due but not impaired**	**Not rated**	**Total**
Cash and cash equivalents	180	-	-	-	180
Debt instruments at FVPL	5,792	298	-	-	6,090
Debt instruments at FVOCI	9,470	1,886	-	-	11,356
Debt instruments at amortised cost	1,036	-	-	-	1,036
Reinsurance assets	2,838	42	-	-	2,880
Total credit risk exposure	**19,317**	**2,225**	**-**	**-**	**21,542**

	2020				
In €000	**High grade**	**Standard grade**	**Past due but not impaired**	**Not rated**	**Total**
Cash and cash equivalents	57	-	-	-	57
Debt instruments at FVPL	4,318	232	-	-	4,550
Debt instruments at FVOCI	8,929	1,758	-	-	10,687
Debt instruments at amortised cost	987	-	-	-	987
Reinsurance assets	2,776	35	-	-	2,811
Total credit risk exposure	**17,067**	**2,025**	**-**	**-**	**19,092**

The Company's maximum exposure to credit risk from insurance contract assets held is €102,000 (2020: €92,000)

The Company actively manages its product mix to ensure that there is no significant concentration of credit risk.

Source: EY's Illustrative Financial Statements

17.31 What information about liquidity risk must be disclosed?

Under IFRS 17, the following disclosures must be made around liquidity risk.

a. A description of how the entity manages the liquidity risk.

b. Separate maturity analyses for portfolios of insurance contracts issued that are liabilities and portfolios of reinsurance contracts held that are liabilities that show, as a minimum, net cash flows of the portfolios for each of the first five years after the reporting date and in aggregate beyond the first five years. An entity is not required to include in these analyses liabilities for remaining coverage measured under the PAA. The analyses may take the form of:

   i. an analysis, by estimated timing, of the remaining contractual undiscounted net cash flows; or

ii. an analysis, by estimated timing, of the estimates of the present value of the future cash flows.

c. c. The amounts that are payable on demand, explaining the relationship between such amounts and the carrying amount of the related groups of contracts, if not disclosed applying (b) of this paragraph.

An example is as follows:

Maturity analysis for insurance and reinsurance contract liabilities (present value of future cash flows basis)

The following table summarises the maturity profile of groups of insurance contract issued and groups of reinsurance contracts held that are liabilities of the Company based on the estimates of the present value of the future cash flows expected to be paid out in the periods presented.

	2021						
In €000	**Up to 1 year**	**1-2 years**	**2-3 years**	**3-4 years**	**4-5 years**	**>5 years**	**Total**
Life Insurance contract liabilities	529	607	767	1,598	1,469	6,550	11,520
Insurance contract liabilities (reinsurance)	473	502	685	812	876	1,302	4,650
Reinsurance contract liabilities (held)	4	3	-	6	5	7	25
TOTAL	**1,006**	**1,112**	**1,452**	**2,416**	**2,350**	**7,859**	**16,195**

Source: EY's Illustrative Financial Statements

Presentation for different types of entity

17.32 How does the presentation differ for mutual entities?

Paragraph 6 of IAS 1 explains that entities that do not have equity, such as some mutual funds, and entities whose share capital is not equity, such as some cooperative entities, may need to adapt the financial statement presentation of members' or policyholders' interests. Prior to implementation of IFRS 17, some entities presented a liability for unallocated divisible surplus to represent the surplus which had not been allocated between participating policyholders prior to reporting the financial statements.

Under IFRS 17 estimates of the expected cash flows to participating policyholders are included in the value of insurance contracts. Unallocated divisible surplus will not be presented as a separate item and the amount is included in the fulfilment cash flows. Accounting mis-matches could give rise to equity in mutual entities (see paragraphs BC266 and BC267).

17.33 How does the presentation differ for entities with run off business?

In this chapter, run off business refers to where an entity has ceased to issue new policies for part or all of its business but is continuing to manage previously issued contracts. (This is sometimes also referred to with regard to life / annuity business as "Closed books".) Provided that a business is a going concern, IFRS 17 presentation applies in the same way

to reporting entities where some or all of the business is running off and to entities that continue to write new business.

Where a reporting entity is not considered to be a going concern, IAS 1 requires additional disclosures which may need to be taken into consideration when applying IFRS 17.

17.34 How does IFRS 17 presentation results differ for consolidated financial statements?

There are no differences in the requirements for presentation for entity level accounts for an insurer or reinsurer and for a group that has issued insurance contracts within one of its group companies. However, as explained above, IFRS 17 needs to be applied with reference to the requirements of other relevant standards.

IFRS 10 sets out the requirements for producing consolidated financial statements. One of the requirements of IFRS 10 is that intra-group balances are eliminated on consolidation (see paragraph B86(b) of IFRS10). For example, where there are intra-group reinsurance arrangements, the consolidated amounts for insurance contracts and reinsurance contracts are not simply the sum of these amounts in the entity financial statements. Rather the amounts presented exclude the intra-group balances such that the value of reinsurance contracts for the consolidated group are only in relation to contracts entered into with parties outside the group.

Transition requirements

17.35 What reconciliations are required at transition?

Paragraph 114 specifies that an entity shall disclose the reconciliation of the CSM applying paragraph 101(c), and the amount of insurance revenue, applying paragraph 103(a), separately for:

a. insurance contracts that existed at the transition date to which the entity has applied the modified retrospective approach;

b. insurance contracts that existed at the transition date to which the entity has applied the fair value approach; and

c. all other insurance contracts.

This will enable users of financial statements to identify the effect of groups of insurance contracts measured at the transition date applying the modified retrospective approach (see paragraphs C6–C19) or the fair value approach (see paragraphs C20–C24) on the CSM and insurance revenue in subsequent periods.

See example below:

20X4	Life Risk	Savings	Partcipating: Direct participating contracts	Partcipating: Investment contracts with DPF	Property and Casualty	Total
Insurance contracts issued						
Insurance revenue						
New contracts and contracts measured under the full retrospective approach at transition	48,543	14,178	687	193	3,452	67,053
Contracts measured under the modified retrospective approach at transition	12,896	3,452	165	46	-	16,559
Contracts measured under the fair value approach at transition	11,864	2,209	105	30	-	14,208
	73,303	**19,839**	**957**	**269**	**3,452**	**97,820**
CSM as at 31 December						
New contracts and contracts measured under the full retrospective approach at transition	29,035	14,382	2,737	558	120	46,832
Contracts measured under the modified retrospective approach at transition	7,006	3,136	614	123	-	10,879
Contracts measured under the fair value approach at transition	6,443	2,005	393	79	-	8,920
	42,484	**19,523**	**3,744**	**760**	**120**	**66,631**
Reinsurance contracts held						
CSM as at 31 December						
New contracts and contracts measured under the full retrospective approach at transition	(23,524)	-	-	-	-	(23,524)
Contracts measured under the modified retrospective approach at transition	(5,701)	-	-	-	-	(5,701)
Contracts measured under the fair value approach at transition	(5,243)	-	-	-	-	(5,243)
	(34,468)	**-**	**-**	**-**	**-**	**(34,468)**

Source: PWC's Illustrative Financial Statements

17.36 Are any disclosures required during transition?

Entities are required to explain how it determined the measurement of insurance contracts at the transition date to enable users of financial statements to understand the nature and significance of the methods used and judgements applied in determining the transition amounts. This must be done for all periods in which disclosures are made applying paragraphs 114(a) or 114(b).

See an example below:

Notes to the consolidated financial statements (continued)

44. Significant accounting policies (continued)

E. Insurance and reinsurance contracts (continued)

viii. Presentation (continued)

Insurance finance income and expenses (continued)

Amounts presented in OCI are accumulated in the insurance finance reserve. If the Group derecognises a contract without direct participation features as a result of a transfer to a third party or a contract modification, then any remaining amounts of accumulated OCI for the contract are reclassified to profit or loss as a reclassification adjustment.[a]

The Group presents insurance finance income and expenses for all other contracts in profit or loss.

ix. Contracts measured under the modified retrospective approach[b]

On transition to IFRS 17, the Group applied the modified retrospective approach in identifying and measuring certain groups of contracts in the life risk, life savings and participating segments at 1 January 2020. The objective of this approach was to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort. The Group applied each of the following modifications only to the extent that it did not have reasonable and supportable information to apply IFRS 17 retrospectively.

The Group applied IFRS 17 retrospectively for all contracts issued or acquired on or after 1 January 2016.

Assessments at inception or on initial recognition

For groups of deferred fixed annuity and universal life contracts issued before 1 January 2008, the Group determined how to identify discretionary cash flows (see Note 29(E)(i)) using information available at 1 January 2020. These contracts represented 12% of the total number o deferred fixed annuity and universal life contracts at 1 January 2020.

Some groups of immediate fixed annuity contracts issued before 30 September 2006 contain contracts issued more than one year apart. For these groups, the discount rates at 1 January 2020 were used for subsequent measurement instead of the discount rates on initial recognition. These contracts represented 8% of the total number of immediate fixed annuity contracts at 1 January 2020.

Contracts without direct participation features

The Group applied the following modifications to certain groups of contracts.

– For groups of contracts issued or acquired before 1 January 2016, the future cash flows on initial recognition were estimated by adjusting the amount at 1 January 2016 or an earlier date (determined retrospectively) for the cash flows that were known to have occurred before that date. The earliest date on which future cash flows could be determined retrospectively for any group of contracts was 1 January 2012.

Source: KPMG's Illustrative Financial Statements

17.37 What disclosures are required if an entity chooses to disaggregate insurance finance income or expenses between P&L and OCI by applying paragraphs C18(b), C19(b), C24(b) and C24(c)?

For all periods in which amounts determined applying these paragraphs exist, the entity shall disclose a reconciliation from the opening to the closing balance of the cumulative amounts included in OCI for financial assets measured at fair value through OCI related to the groups of insurance contracts in accordance with paragraph 116.

The reconciliation shall include, for example:

- gains or losses recognised in OCI in the period; and
- gains or losses previously recognised in OCI in previous periods reclassified in the period to P&L.

See the example below:

12.4. Reconciliation of amounts included in OCI for financial assets at FVOCI

On transition to IFRS 17, the Company applied the modified retrospective approach for certain groups of contracts in the immediate annuity portfolio, refer to Note 1.1.1.3.2 for details. *IFRS 17.C18(b)(i)*

The movement in the fair value reserve for financial assets measured at fair value through OCI that are related to the annuity portfolio is disclosed below: *IFRS 17.116*

In €	2021	2020
Cumulative other comprehensive income, opening balance	**13,924**	**16,143**
Gains or losses recognised in other comprehensive income in the period	7,580	(2,294)
Amounts recognised in profit or loss during the period	79	75
Cumulative other comprehensive income, closing balance	**21,583**	**13,924**

Source: EY's Illustrative Financial Statements

17.38 What IFRS 17 comparative information is required?

There is a requirement when transitioning to a new IFRS to provide financial statements (comparatives) as of the beginning of the period immediately preceding the date of initial application.

The dates that follow apply for entities with quarterly financial reporting and an assumed date of initial application of 1 January 2023. Analogous dates would apply in other situations.

On 31 March 2023 the entity will report the following on the new IFRS 17 basis.

- the 31 December 2022 statement of financial position
- the statement(s) of financial performance for the 3-month period ending 31 March 2023
- the 31 March 2023 statement of financial position will not be presented, but will be necessary to the extent needed to prepare the 31 March 2023 statement(s) of financial performance
- the 31 December 2021 statement of financial position

- the statement(s) of financial performance for the 3-month period ending 31 March 2022
- the 31 March 2022 statement of financial position

17.39 Can more than one year of IFRS 17 comparative information be presented?

Yes, an entity is permitted to present more than one year of IFRS 17 comparative information (paragraphs C25-C28). The beginning of the earliest adjusted comparative period presented (which would be the beginning of the period immediately preceding the date of initial application when only one year of comparative information is presented) is called the "transition date". For a 31 December reporter adopting IFRS 17 for the first time from 1 January 2023, the transition date would be 1 January 2022. If an entity chooses to present two years of comparative information (both of which are based on IFRS 17), the transition date would be 1 January 2021. See paragraphs C2 and C25.

17.40 If provided, how is comparative information for earlier periods presented?

If the comparative information and disclosures for earlier periods are adjusted by applying IFRS 17, Question 17.39 applies. If the comparative information and disclosures for earlier periods are unadjusted, paragraph C27 requires the entity to "clearly identify the information that has not been adjusted, state that it has been prepared on a different basis, and explain that basis."

17.41 If the implementation of IFRS 9 is deferred until 1 January 2023, what is the interaction with the IFRS 17 comparative financial statements?

The insurer has three options:

Option 1: The insurer defers the application of IFRS 9 until the effective date of IFRS 17. Hence, IFRS 9 is applicable for reporting periods starting on or after 1 January 2023 only. For the purpose of the transition calculation in 2022, this insurer would value the assets applying IAS 39 during the comparative period; or

Option 2: The insurer defers the application of IFRS 9 until the effective date of IFRS 17 but chooses to restate the comparatives applying IFRS 9 (as long as an insurer does not need to apply hindsight). Note also that if an insurer sold any assets during 2022, the insurer can't apply IFRS 9 to these assets and would still have to apply IAS 39); or

Option 3: An insurer adopts IFRS 9 on 1 January 2022 and hence the insurer only restates IFRS 17 but not IFRS 9 during the comparative period of IFRS 17.

17.42 If IFRS 9 is implemented before IFRS 17, are financial assets re-designated when IFRS 17 is implemented?

The guidance for re-designation and related disclosures is in paragraphs C29-C33. If there are assets designated as fair value through P&L to avoid an accounting mismatch, that designation must be revoked if the accounting mismatch no longer exists under IFRS 17. Otherwise, re-designation of assets is permitted but not required.