Paper 2 –Submission Paper: Underlying items

Potential Implementation Questions

Insurance contracts with direct participation features are defined based on the concept of underlying items. For many participating insurance contracts, the dividend scale / credit rate does not only depend on return of investment portfolio but also on non-economic experience such as mortality / lapse / expenses. The question would like to explore two fundamental concepts:
1) The definition of underlying items. What are the components?
2) Options on the accounting treatment of the underlying items under VFA

Analysis of the Questions

1) The definition of underlying items and what are the components

Underlying items are defined in Appendix A. The standard uses words such as assets, portfolio of assets and net assets of entity, but has been silent on non-economic factors such as expense and lapse experience. In actual practice, the insurer will always consider various experience of the insurance portfolio when deciding on crediting rates or dividends to share with the policyholders, not only limited to assets return. When the non-economic experience deviates from our expectation at pricing stage, the insurers usually consider these experience variance in the future sharing with policyholders. These items seem to fit the definition of underlying items.

2) Options on accounting treatment of the underlying items under VFA

We illustrate the options and financial impacts with two examples. Please refer to the spreadsheet for the mechanics (appendix).

Expense Example Fact Pattern

This VFA contract has a 90% sharing ratio. The insurer expects future non attributable expenses to increase by $100 in present value.

(i) The change in assumption led to a decrease in present value of dividend of $90.
(ii) The future additional expense was determined to be non-attributable under IFRS 17.

We present a few different views on the accounting treatment of the underlying items.

View 1A: The fair value of underlying item consists of the market value of investment fund and the net asset attributable to the policy on statutory basis (excluding any surplus from the investment fund). Since any non-economic variance measured under statutory basis directly impacts the change in dividend scale, this is taken as the fair value of underlying item. Because of the future change in expenses are used to unlock CSM, this creates a P/L impact in current year.

View 1B: The fair value of underlying item consists of the market value of investment fund and the net asset attributable to the policy on IFRS basis (excluding any surplus from the investment fund). The expense in this example is non-attributable, this does not impact

CSM. The fair value changes of the underlying assets have unlocked CSM and no P/L impact is resulted.

View 1C: The fair value of underlying item consists of the market value of investment fund and the net asset attributable to the policy on FV basis (excluding any surplus from the investment fund). Neither statutory nor IFRS basis is adopted. Instead, the fair value of the underlying items needs to be separately defined.

View 1D: We only take the financial assets as the underlying items and the result is same as View 1B for this example.

Reinsurance Example Fact Pattern

The company paid additional reinsurance premium of $50.

(i) The variance resulted in a financial impact on statutory basis (after considering the effect of statutory reserve) of $40.There is no change to future reinsurance premium and recovery.
(ii) This led to a decrease in present value of dividend of $36.
(iii) The additional reinsurance premium relates to future service and will unlock CSM of the reinsurance contract by $50
(iv) For simplicity, there is also no other cash flow or change in BEL and RA in the period. The net asset attributable to the reinsurance contract over the period increases by $3 ($50 - $50 + $3) on IFRS basis, being the amortisation of CSM.

View 2A: Similar to our expense example, calculating the reinsurance result using statutory basis creates volatility in the P&L. This is because the statutory reinsurance result is used to unlock the CSM in the change in underlying assets line.

View 2B: This example varies from the expense example. You can see the net profit ends up at the same number of insurance revenue. The $3 being generated from reinsurance CSM is part of the underlying item which is used to unlock the direct contract CSM. This is also consistent with the spirit of VFA approach to minimize balance sheet volatility in case of the entity holding the underlying item.

View 2C: Similar to View 1C on the unclear fair value concept.

View 2D: This presents a comparison to View 2B. Without the reinsurance result at the underlying item, the result will show the $3 release of reinsurance CSM in the net profit. If non-asset component such as reinsurance results is part of the underlying items, the positive or negative results will get eliminated in P/L. This is not the case here in View 2D.

Conclusion:

View A creates unnecessary volatility. As for View B on insurance liability, the one closest to fair value should be the liability value booked under IFRS17, and hence the fair value shall be the IFRS net asset allocated to the policy. Also, the result satisfies the spirit of VFA. View D is also worth consideration and depends on our view of the first question of this discussion.

Paragraphs of IFRS 17 Standards

Appendix A
Underlying items - 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.

Insurance contract with direct participation features - An insurance contract for which, at inception:
(a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;
(b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and
(c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

45
For insurance contracts with direct participation features (see paragraphs B101 – B118), the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for the amounts specified in subparagraphs (a) – (e) below. An entity is not required to identify these adjustments separately. Instead, a combined amount may be determined for some, or all, of the adjustments. The adjustments are:

(a) the effect of any new contracts added to the group (see paragraph 28);
(b) the entity's share of the change in the fair value of the underlying items (see paragraph B104(b)(i)), except to the extent that:

(i) paragraph B115 (on risk mitigation) applies;
(ii) the entity's share of a decrease in the fair value of the underlying items exceeds the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or
(iii) the entity's share of an increase in the fair value of the underlying items reverses the amount in (ii).

89
For insurance contracts with direct participation features, for which the entity holds the underlying items, an entity shall make an accounting policy choice between:
(a) including insurance finance income or expenses for the period in profit or loss; or
(b) disaggregating insurance finance income or expenses for the period to include in profit or loss an amount that eliminates accounting mismatches with income or expenses included in profit or loss on the underlying items held, applying paragraphs B134–B136.

B101

Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items. Hence, they are defined as insurance contracts for which:

(a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items (see paragraphs B105 – B106);
(b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items (see paragraph B107); and
(c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items (see paragraph B107).

B104
The conditions in paragraph B101 ensure that insurance contracts with direct participation features are contracts under which the entity's obligation to the policyholder is the net of:
(a) the obligation to pay the policyholder an amount equal to the fair value of the underlying items; and
(b) a variable fee (see paragraphs B110 – B118) that the entity will deduct from (a) in exchange for the future service provided by the insurance contract, comprising:
(i) the entity's share of the fair value of the underlying items; less
(ii) fulfilment cash flows that do not vary based on the returns on underlying items.

B106
The pool of underlying items referred to in paragraph B101(a) can comprise any items, for example a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity, as long as they are clearly identified by the contract. An entity need not hold the identified pool of underlying items. However, a clearly identified pool of underlying items does not exist when:
(a) an entity can change the underlying items that determine the amount of the entity's obligation with retrospective effect; or
(b) there are no underlying items identified, even if the policyholder could be provided with a return that generally reflects the entity's overall performance and expectations, or the performance and expectations of a subset of assets the entity holds. An example of such a return is a crediting rate or dividend payment set at the end of the period to which it relates. In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set, and does not reflect identified underlying items.