IFRS 17: How to choose the measurement model

[This article is one in a series of articles published on behalf of the IFRS 17 CSM Working Party. Members are Antoon Pelsser, Asim Ghosh, Clarence Er, Huina Zhang, James Thorpe, Joanna Stansfield, Kruti Malde, Natalia Mirin (Deputy Chair), Richard Dyble, Rob Walton, Timothy Berry, Weihe Qin and Wijdan Yousuf (Chair).]

Within IFRS17 there are three possible measurement models: the General Model[1] (GM), the Premium Allocation Approach (PAA) and the Variable Fee Approach (VFA). The GM is the "default" measurement model for insurance contracts. For contracts with a coverage period shorter than one year, there is the *option* to choose PAA as a simplified measurement model. For contracts with direct participation features it is *mandatory* to use VFA. For contracts that do not classify as direct participation, it is not allowed to use VFA. In the sections below we discuss the eligibility criteria for PAA and VFA.

1 Variable Fee Approach

The VFA is the measurement model for contracts with direct participation features. These are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items. For contracts with direct participation features it is *mandatory* to use VFA.

At initial recognition, there is no difference in measurement between contract with or without direct participation features: all types of contracts are measured in the same way (barring the PAA, discussed below). This means that that the CSM at initial recognition is measured the same way under GM or VFA.

The key difference between the VFA and the GM is only evident at subsequent measurement (as stated in paragraph 45 of the IFRS 17 text). VFA introduces the concept of a "Variable Fee", which is loosely defined as the entity's share of the underlying items as a fee for the services it provides. For example, in the case of unit-linked products, variable fee is nothing but the non-unit cash flows. In the case of discretionary with profits products, the variable fee would ideally comprise of shareholder transfers.

The main benefit of applying VFA would be to better manage the volatility of the entity's balance sheet. The difference between GM and VFA is the ability to bring economic movements into the CSM each period, in contrast to the GM where the CSM is only updated for changes in non-financial assumptions (see par B97(a)). The updating of the CSM under VFA reflects the fact that future profitability is significantly impacted by market movements. Without this mechanism, the insurance service result for these products would not reflect the reality, and the net investment result would be more volatile.

The definition of contracts with "direct participation features" is given in paragraphs B101 - B108 of the IFRS 17 text. Paragraph B101 states that 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:

- the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;
- the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items;
- 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.

The need for contractual linkage is a crucial aspect in the definition. In absence of this, certain non-participating savings contracts also would have been eligible for the VFA approach. In such contracts the

[1] The GM is also referred to as the Building-Block Approach (BBA) by many companies.

benefit payable to the policyholder includes sum assured plus regular additions which are derived based on the returns on underlying assets. However, the contractual terms do not define underlying assets and this is left at the discretion of the entity. In the case of unit linked or participating contracts, contractual linkage exists by way of policy terms, PPFM or any other regulations governing these types of products.

Concerning the notions of "substantial share" and "substantial proportion of any change", no explicit guidance is provided in the IFRS17 text. In terms of implementation, entities will have to devise formal tests and the current text leaves room for interpretation. For example, one possible interpretation is that the entity needs to estimate PV of investment income / PV of cash outflows at policy inception. If this ratio is higher than a certain percentage, then it can be interpreted as substantial share of pay outs comprises of returns on underlying items

Paragraph B102 states that an entity shall assess whether the conditions in paragraph B101 are met using its expectations at <u>inception of the contract</u> and shall not reassess the conditions afterwards.

In the paragraphs below, we will discuss several examples of contract features to illustrate when VFA can be applied and when it cannot be applied.

Unit-Linked Insurance

The most straightforward application of VFA is for unit-linked insurance contracts, where the premiums are invested in an investment fund on behalf of the policyholder. The pay-out to the policyholder is directly linked to the performance of the underlying investment fund.

Minimum Return Guarantees

An important variant are contracts where the pay-outs to the policyholder are subject to minimum return guarantees. This is explicitly discussed in paragraph B108. In this case, there will be scenarios in which the pay-outs vary with the changes in the fair value of the underlying items because the return on the investment fund exceeds the guaranteed return. On the other hand, there will be scenarios in which the pay-outs do not vary with the changes in the fair value of the underlying items because the guaranteed return is paid out. The entity's assessment of the variability for this case will reflect a <u>probability-weighted average</u> of all these scenarios.

Linked to a Benchmark

Another important variant are contracts where the pay-outs to the policyholders are linked to a benchmark, such as the yield on a basket of government bonds, a market index or a specified sub-set of the net assets of the entity. This case is explicitly discussed in paragraph B106, which states that the pool of underlying items can comprise of <u>any items</u>, as long as they are <u>clearly identified</u> by the contract. Furthermore, it is stated that the entity need not hold the identified pool of underlying items.

Management Discretion

Finally, we want to point out that paragraph B105 states that the share referred to in paragraph B101(a) does not <u>preclude</u> the existence of the <u>entity's discretion</u> to vary the amounts paid to the policyholder. However, the link to the underlying items must be <u>enforceable</u>.

Pooled Assets with Profit-Sharing

We also want to include an example of contract features where it is less clear if VFA can be applied. For this example, we consider *different groups* of policyholders (with different types of insurance contracts and guarantee levels) whose premium payments are all invested in the *same pool* of underlying items. At the end of each year, the management of the entity decides which amount of the return of the asset pool return is made available for profit-sharing. Furthermore, the management of the entity also decides on the exact allocation of the profit-sharing pool to individual groups of policyholders.

For this example, there is a clearly identified pool of assets, which is defined at entity level. There exists also a clear link between the returns of the assets and the amounts available for profit-sharing. So, the VFA criteria 1-3 are satisfied at asset-pool level. However, due to the "pooled" profit-sharing, in combination with the elements of management discretion, it is unclear if the VFA criteria 1-3 are satisfied for each *policyholder* participating in the profit-sharing pool.

2 Premium Allocation Approach

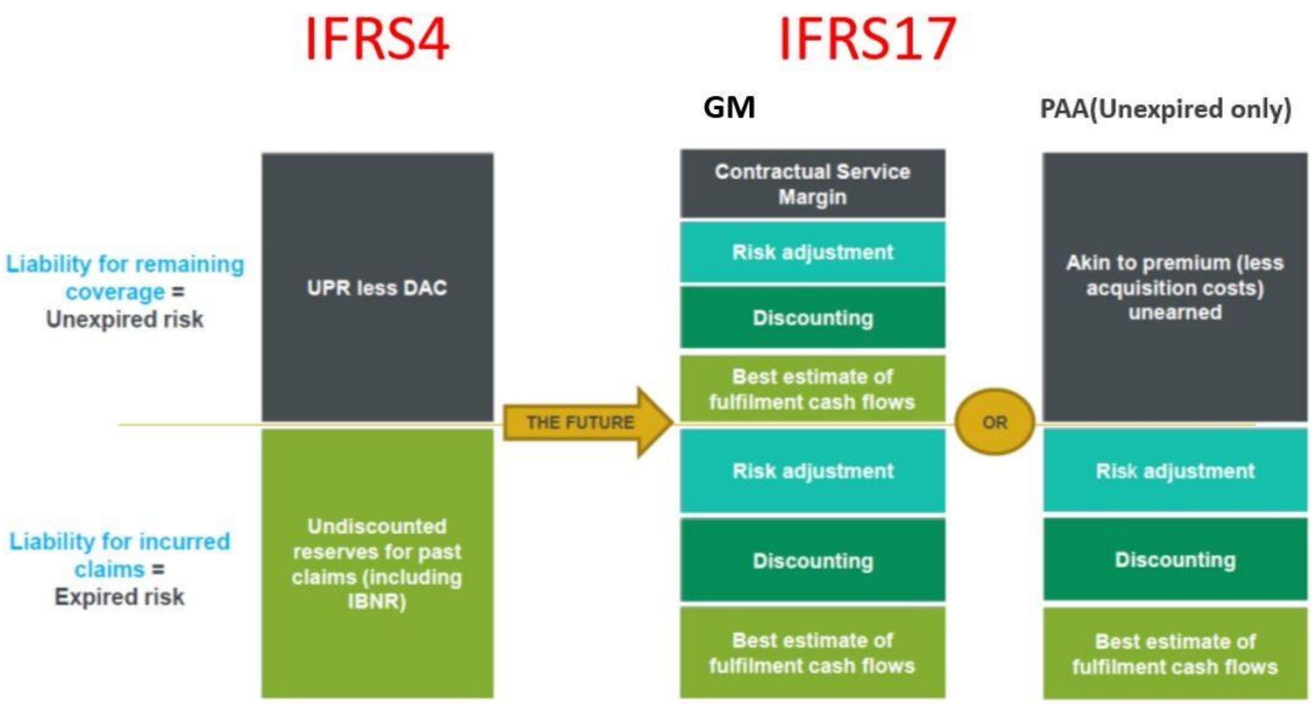
The IFRS17 text states in paragraph 53 that an entity has the option to simplify the measurement of a group of insurance contracts using PAA if, and only if, at the inception of the group of contracts:

- the coverage period of each contract in the group of contracts is one year or less;
- the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group of contracts that would not differ materially from the one that would be produced applying the GM.

Paragraph 54 states that the "not materially different" criterion is violated 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.

An entity is therefore allowed to opt for the simplified PAA to measure the liability for remaining coverage for contracts with a coverage period of less than one year. Furthermore, the entity should reasonably expect that the simplified measurement does not differ materially from the measurement produced by the GM.

The figure below shows the calculation approaches under IFRS 4, IFRS 17 GM and IFRS 17 PAA. The IFRS 17 approaches differ for the remaining coverage period, with PAA using a similar calculation to IFRS 4.



It is anticipated that most Group Protection policies would qualify for PAA, due to their term and the similarity in measuring liabilities under both GM and PAA. However, where there are longer tail products, work is still ongoing to determine whether these could be eligible under PAA given the underlying risk event was on a 1-year product.

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