CSM adjustments for experience variances

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

1. Introduction

Almost always, the actual experience emerging for (re)insurance contracts will be different from the assumptions used at the end of the preceding valuation period. In this article, we explore the cases in which the CSM needs to be adjusted for experience variances.

2. Background

After being calculated at initial recognition, the CSM is adjusted at subsequent measurement at the end of each reporting period. The changes in fulfilment cash flows that adjust the CSM must be related to future service. Experience variances are generally thought of as being related to the current or past periods, therefore belonging to the income statement rather than adjusting the CSM. However, certain experience variances, which are recorded in the income statement in the current period, may have a knock-on impact on the fulfilment cash flows related to future service. These must be considered when adjusting the CSM.

For example, for a group of life insurance contracts, higher or lower mortality in a period will result in either positive or negative experience variance which will affect the income statement. At the same time, the number of deaths in the period will directly affect the remaining number of policies within the group, therefore creating an impact on fulfilment cash flows related to future services. The same reasoning may apply to experience variances arising from health (e.g. critical illness) and lapse risks. In these cases, we need to make sure that the impact that in-period experience variances have on future fulfilment cash flows is appropriately assessed and CSM is adjusted for such an impact.

3. Contracts without direct participating features

For contracts without direct participating features, in addition to the knock-on impact of current period experience variances on future fulfilment cash flows as described above, B96(a), (c) and (d) set out the fulfilment cash flows adjustments that IFRS 17 defines as being related to future services. These are as follows.

B96(a): "*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…*"

As such, every period we will have to look at the premium experience variance and assess or set an assumption, based on the type of contract and its features, what part of the premium experience variance in period (if any) is related to future services. The identified proportion of premium related to future services will therefore adjust the CSM. The remaining part of the premium experience variance will be regarded as related to the current or past periods and will be recorded in the relevant part of IFRS 17 income statement.

B96(c): "*differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period…*" This paragraph states that for policies without direct participating features the experience variance in the investment component payable within a period will be related to future services and therefore will adjust the CSM. Therefore, we will need to make sure the CSM is adjusted appropriately when making payments under contracts with investment components.

B96(d): "*changes in risk adjustment for non-financial risk that relate to future service*".

Effectively this paragraph states that every period the change in risk adjustment has to be considered and assessment made to decide if any part of this change is related to future services. The part that is related to future services would therefore adjust the CSM.

Additionally, B98 states that a change in discretionary cash flows for contracts without direct participation but with discretionary payment elements would also relate to future services and as such will adjust the CSM for such groups of contracts.

All the above assessments for products without direct participating features must be performed and calculated using appropriate locked-in interest rates to adjust the CSM. The difference between the adjustments calculated at locked-in and current interest rates in General Model will have to be appropriately allocated to the finance income or expenses line. In this respect, potential future interest rate volatility in conjunction with changes in future cashflows, may result in an increased volatility of the income statement. This issue generates some concerns within the industry.

4. Contracts with direct participating features

For insurance contracts with direct participating features, changes that adjust the CSM must reflect the nature of the Variable Fee. The base principle of experience variances adjusting the CSM will be the same as in the General Model:

if any part of experience variance is related to future services, it should adjust the CSM. Experience variances that are related to the current or past periods will be recorded in the income statement.

In this respect, B112 states that changes in the entity's share of the underlying items relate to future service and therefore adjust the CSM. Therefore, if the actual entity's share of the underlying items within the period proves to be different from the expectation set at the beginning of the period (either due to a review of the future assumptions or the current period experience variance), IFRS 17 defines this experience variance as related to future services and therefore adjusting the CSM. For example, if in a participating in-period variances would impact the value of underlying fund and through this the entity's share, then these variance (whether economic or demographic) will adjust the CSM.

The composition of the Variable Fee, as defined in B104, is the difference between the entity's share of the underlying items and non-variable fulfilment cash flows. Non-variable fulfilment cash flows in the Variable Fee Approach model are the cash flows that do not directly vary with the underlying items, for example per policy maintenance expenses or fixed death benefits. As such, these cash flows are similar and treated in line with the cash flows for contracts without direct participating features described above except for the discount rates that apply. The same features and judgements as set out in section 3 shall apply.

One more difference of the Variable Fee Approach from the General Model is that as per B113(b) the changes in effect of the time value of money and financial risks not arising from the underlying items are defined as the ones related to future service and therefore the ones that will adjust the CSM. The exception is the cases and extent to which financial risk mitigation applies. In terms of experience variance example affecting the CSM, in this case the standard states that the changes in discount rates or level of financial risk within the period will be regarded as related to future services and adjust the CSM. This treatment of financial experience variance in the period is specific to the Variable Fee Approach and differs from the General Model, where in the latter neither in period nor future changes in the time value of money or financial risks would adjust the CSM.

5. Conclusion

In summary, the ground rule for adjusting the CSM is that all the adjustments must be related to future services. Experience variances, while emerging in the current period, may be fully or partially related to future services (or have an impact on fulfilment cash flows related to future services). There are differences between General Model and Variable Fee Approach in the definitions of which items of experience variances are regarded as related to future services. Firms will need to assess and analyse the applicability of the standard to experience variances recorded under their contracts and be able to explain and justify adjustments made to the CSM arising from these experience variances.

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