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IFRS-FA – öffentliche SITZUNGSUNTERLAGE

Sitzung:	67. IFRS-FA / 05.06.2018 / 09:00 – 11:00 Uhr
TOP:	04 – IFRS 17 Versicherungsverträge
Thema:	Aktueller Stand der Diskussion bei Implementierungsthemen und im Indossierungsverfahren
Unterlage:	67_04_IFRS-FA_IFRS17_CN

Agenda

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1 IFRS 17 basic requirements for CSM release

2 Challenges around the CSM release

3 Open topics

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1. IFRS 17 basic requirements for CSM release
2. Challenges around the CSM release
3. Open topics

Introduction

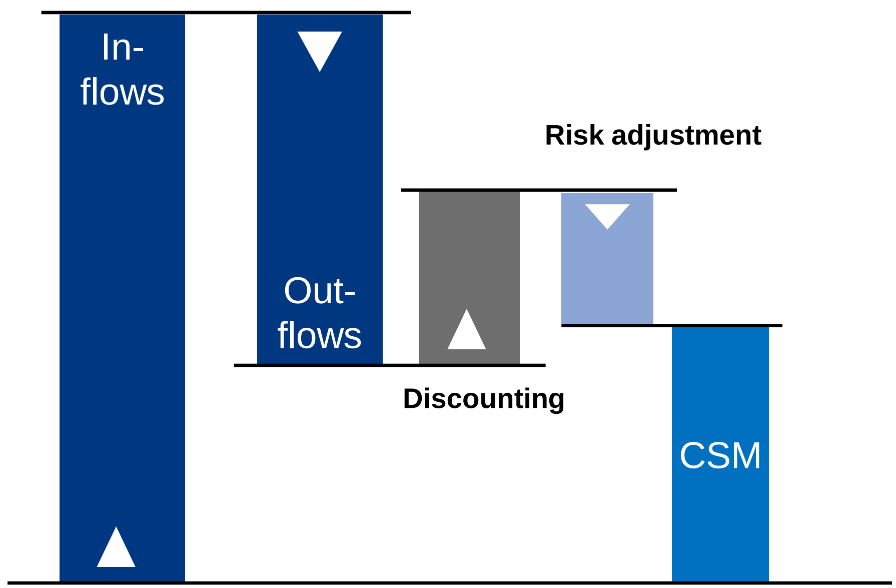
Contractual Service Margin (CSM)

A component of the carrying amount of the asset or liability for a group of insurance contracts representing the unearned profit the entity will recognise as it provides services under the insurance contracts in the group.

On initial recognition

The CSM is the equal and opposite amount to the total of:

- the fulfilment cash flows;
- the derecognition of any asset or liability recognised for insurance acquisition cash flows; and
- any cash flows arising from the contracts in the group at that date



Understanding CSM mechanics (1/3)

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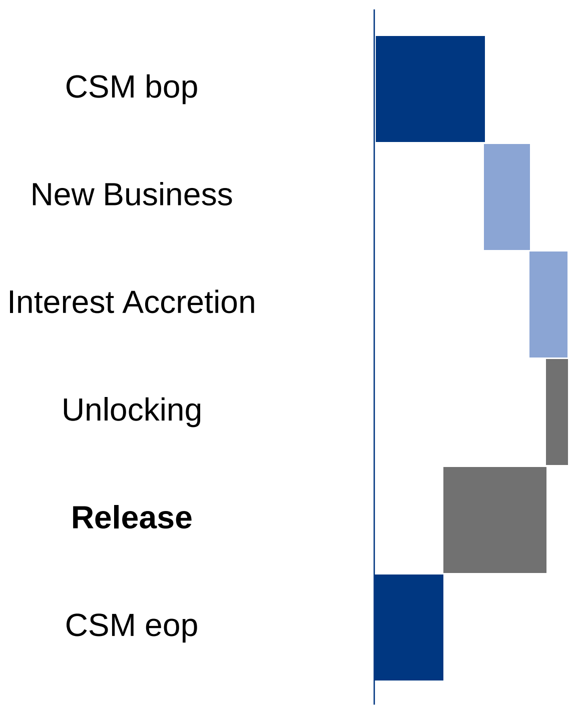
Subsequent measurement

Simplified illustration:



⇒ **IFRS 17 – market value oriented balance sheet:**

- CSM representing profits to be earned in the future
- vs. already earned profits (⇒ equity)

⇒ **Variable Fee Approach (VFA):**

- Full CSM unlocking for non-financial and financial assumptions
- Earning of investment margin via CSM release

⇒ **(Mod.) Building Block Approach (BBA):**

- Unlocking for non-financial assumptions only
- Explicit interest accretion with lock-in rate
- Investment result driven by IFRS 9

Understanding CSM mechanics (2/3)

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Insurance Contracts

IFRS 17: §§44e), 45e), B119

CSM release reflects **transfer of services** in the period

Further specification

B119: **CSM release** = $CSM_{eop} \bullet \dfrac{CU_{\text{current period}}}{CU_{\text{current period}} + CU_{\text{future periods}}}$

CU (coverage units): Quantity of coverage provided, considering quantity of benefits provided and expected coverage duration

BC279-283: Background & IASB's rationale

Investment Contracts with DPF

IFRS 17: §71 c)

CSM release reflects **transfer of investment services** under the contract

No further specification

Understanding CSM mechanics (3/3)

1	Identify the coverage units in the group	• Number of CU: 1.000 • Current period: 100 – future periods: 900
2	Allocate CSM equally to coverage units	• CSM of 5.000 ⇒ 5 per CU • 100 * 5 = 500 allocated to current period • 900 * 5 = 4.500 allocated to future periods
3	Recognize CSM release in P&L	• Recognize CSM release of EUR 500 in P&L

$$\text{CSM release} = 5.000 \bullet \frac{100}{100 + 900}$$

- Mechanical approach
- Open question: How to define the coverage units for different products?

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Development of requirements on the CSM release

- **2010 ED** proposed to recognise the CSM as income in profit or loss over the coverage period in **a systematic way** that best reflects the **exposure from providing insurance coverage**, as follows:
  a) on the basis of the passage of time, but
  b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time.

- **2013 ED** proposed to recognise the remaining CSM in profit or loss over the coverage period in the systematic way that best reflects the **remaining transfer of services** that are provided under the contract.
- **2013 ED BC**: Consistency with revenue recognition principles. The proposals in this Exposure Draft are consistent with the core principle of the 2011 Exposure Draft Revenue from Contracts with Customers.

- **Agenda Paper 2C May 2014** – What services are provided under an non-participating insurance contracts?

  The entity provides the service of **standing ready to compensate** a policyholder if an insured event takes place during the coverage period.

- **Agenda Paper 2C June 2015** – What is the pattern of delivery of the investment-related services?

  Potential pattern of delivery of investment-related service based on:

  (a) the passage of time; (b) the amount of assets under management; or the combination of both.

  ➢ Staff proposal: an entity should recognise the contractual service margin in profit or loss on the basis of **the passage of time**.

- The concept of **coverage units** was introduced in a relatively later phase of drafting IFRS 17, in order to reflect different sizes of the contracts in the group when releasing the CSM on the basis of the passage of time.

CSM release on the basis of the passage of time

Example of a hurricane insurance contract

- Coverage period: 1 year
- Hurricane season: June – September
- Premiums: 1000
- Expected claims in respective quarter: Q1 = 0, Q2 = 200, Q3 = 600, Q4 = 0
- No discounting effect
- Risk adjustment: 100
- Claims incurred as expected

- CSM (t = 0) = 1000 – 800 – 100 = 100
- Release of the CSM in each quarter: 100 / 4 = 25
- Release of the RA: Q1 = 0, Q2 = 25, Q3 = 75, Q4 = 0

t = 0	**Q1**	**Q2**	**Q3**	**Q4**
Release PVFCF	0	200	600	0
Release RA	0	25	75	0
Release CSM	25	25	25	25
Insurance Revenue	**25**	**250**	**700**	**25**
Actual Claims	0	200	600	0
Insurance Service Expenses	**0**	**200**	**600**	**0**
Insurance Service Result	**25**	**50**	**100**	**25**

The entity is standing ready to compensate the policyholder not only in the hurricane season, but over the whole coverage period.

Appropriate interpretation of coverage units (1/2)

IFRS 17.B119(a)

[…] The number of **coverage units** in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract **the quantity of the benefits provided** under a contract and its **expected coverage duration**.

IFRS 17 Basis for Conclusions

- IFRS 17.BC279: **insurance coverage** is the **defining service** provided by insurance contracts
- IFRS 17.BC280: [..] the entity provides multiple services in return for an expected fee based on the expected duration of contracts, […] the entity should **recognise** that **fee** over the coverage period **as the insurance services are provided**, not when the returns on the underlying items occur.

- Objective of the CSM release:
  - ➢ To reflect the services provided under the group of insurance contracts in each period → Different levels of service across periods should be reflected in the determination of coverage units
- The key principle is consistent with revenue recognition principles under IFRS 15: Revenue is recognised as the entity satisfies a performance obligation by transferring a promised good or service.
  - ➢ However, IFRS 17 defines what the service of an insurance contract is, i.e. standing ready to compensate the policyholder in case of an insured event.

Open question: what is the quantity of the benefits provided?

Appropriate interpretation of coverage units (2/2)

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Feb 2018 TRG Agenda Paper 5

- Coverage units were introduced to achieve an appropriate allocation of the CSM of a group that contains **contracts of different sizes**
- Use of the **maximum level of cover** and the expected level of cover in periods, for insurance contracts without investment component
  - ➢ Issue: The maximum cover leads to odd revenue recognition pattern in some cases and it is a poor proxy for profitability.

May 2018 TRG Agenda Paper 5

- The determination of coverage units is not an accounting policy choice but involves **judgement and estimates** to best achieve **the principle of reflecting the services provided in each period**. Those judgements and estimates should be applied systematically and rationally.
- Quantity of benefits provided under a contract: The benefits expected to be received by the policyholder, not the costs of providing those benefits expected to be incurred by the entity.
- A policyholder benefits from the entity **standing ready to meet valid claims**, not just from making a claim if an insured event occurs. The quantity of benefits provided therefore relates to the amounts that can be claimed by the policyholder.
- Some methods may be appropriate if they **are reasonable proxies for the services provided** under the group of insurance contracts in each period, e.g.:
  1. a **straight-line allocation over the passage of time**, but reflecting the number of contracts in a group.
  2. a method based on the maximum contractual cover in each period.
  3. a method based on the amount the entity expects the policyholder to be able to validly claim in each period if an insured event occurs.
  4. methods based on premiums.
  5. methods based on expected cash flows.

Revenue recognition under IFRS 17 vs. IFRS 15

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	IFRS 17	IFRS 15
Core principle	• Insurance revenue recognised in a period depicts the **transfer of promised services** at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services.	• An entity shall recognize revenue to depict the **transfer of promised services (or goods)** to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services.
Components	• Amounts related to the provision of services: • Release FCF • Release RA • Release CSM ➢ Reflect the transfer of services in the period • Amounts related to insurance acquisition cash flows	• Five-step approach ➢ Step 1: Identify the Contract(s) ➢ Step 2: Identify the Performance Obligations ➢ Step 3: Determine the Transaction Price. ➢ Step 4: Allocate the Transaction Price to the Performance Obligations ➢ Step 5: Recognize Revenue **when (or as) the Entity Satisfies a Performance Obligation**.

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Open topics

- **Do the services provided by an insurance contract include investment-related services?**
  - **Insurance contract with direct participation features (VFA)**: contracts that provide both insurance services and investment-related services → Services provided refer to both insurance and investment services
  - **Insurance contract with investment component under general model**: controversial opinions on whether such contracts should be treated as providing only insurance services.

    Example of a deferred fixed annuity:

    - Accumulation period: 10 years; After 10 years: Option to choose a life contingent annuity (with guaranteed annuitization rate), alternative is a lump-sum payment.
    - No death benefit.
      - ➢ Deferred fixed annuity is an insurance contract due to the longevity risk of the life contingent annuity.
      - ➢ If it is treated as providing only insurance services, no CSM release during the first ten years of the deferred annuity.
      - ➢ CSM release only starts when the policyholder elects the annuity option. If the policyholder elects the lump sum, full profit recognition in the point in time in which the payment to the policyholder is performed.

    ⇨ **Focus on insurance coverage only does not reflect an appropriate profit pattern.**

- **IFRS 17.BC280:** […] the entity provides multiple services in return for an expected fee based on the expected duration of contracts, […] the entity should recognise that fee over the coverage period as the **insurance services are provided**, not when the returns on the underlying items occur.

  ⇨ Narrow scope of amemdment may be necessary

- **The determination of coverage units involves judgement and estimates.**
- **Focus on insurance coverage only not workable for insurance contracts with investment component**