Contractual service margin amortisation under the general model
Issues Paper

Introduction

1 In January 2019, the IASB tentatively decided to amend IFRS 17 so that in the general model the contractual service margin ('CSM') is recognised in profit or loss based on both insurance coverage and investment return service, if any. An investment return service exists only when an insurance contract includes an investment component.

2 As a result, preparers had indicated that IFRS 17 requirements are only appropriate for certain types of contracts. For other contracts, for example some deferred annuities, CSM cannot be amortised over the period in which investment services are provided (i.e. during the accumulation phase).

3 In May 2019, the IASB tentatively decided to specify in IFRS 17 criteria that must be met for an insurance contract to provide an investment return service. The criteria are necessary conditions for such a service but are not determinative—such service might not exist even if the criteria are met. The criteria are:

(a) there is an investment component, or the policyholder has a right to withdraw an amount;

(b) the investment component or amount the policyholder has a right to withdraw is expected to include a positive investment return; and

(c) the entity expects to perform investment activity to generate that positive investment return.

4 The IASB, in May 2019, also tentatively decided to include in IFRS 17 guidance that a positive investment return can occur even when the absolute return is negative (for example, in a negative interest rate environment).

Contracts with investment components

5 For some contracts under the general model, in addition to insurance coverage, the entity provides a service to the policyholder in terms of providing both the policyholder's investment and an investment return that would not otherwise be available to the policyholder because of amounts invested, expertise, etc. Therefore, EFRAG assesses that the IASB proposals provide relevant information about the services being provided to the policyholder. Therefore, the resulting CSM amortisation provides a faithful representation of those services being provided.

Contracts without investment components

View 1– Agree with the IASB tentative decision

6 A right for the policyholder to withdraw money exists in many insurance contracts. such a right for the policyholder to withdraw money (or to transfer an amount to another party) seems to indicate the entity is providing an investment-return service in the deferred annuity contracts.

7 The identification of investment return services could be complex and require significant judgement. There would be subjectivity in assessing the weighting between the investment return service and insurance coverage services in order to determine the coverage units and the release pattern of the CSM. However, an entity is already required to make similar assessments for contracts which provide more than one type of insurance coverage and disclosures relating to this significant judgement will facilitate users' understanding on the entity's perspective when amortising CSM.

No View 2 proposed – Following the IASB tentative decision in May, EFRAG has not heard of any proposal to further amend the standard

Summary of the EFRAG IAWG discussion – May 2019

Description of the remaining concerns

8 On the basis of the IASB tentative decision in May those EFRAG IAWG members who had this issue have indicated that, subject to the wording of the upcoming Exposure Draft, the issue has been resolved for UK.

9 Some EFRAG IAWG members questioned the meaning of certain criteria in paragraph 3 above in assessing whether an investment return service exists:

(a) What was meant by a positive investment return; and

(b) What was meant by a right to withdraw an amount.

Summary of EFRAG TEG discussion – May 2019

10 EFRAG TEG members had already discussed the tentative decision of the IASB to amend the requirements in IFRS 17 in the April meeting.

11 EFRAG TEG members noted the feedback of the IAWG that on the basis of the IASB tentative decision in May those EFRAG IAWG members who had a residual issue indicated that, subject to the wording of the upcoming Exposure Draft, the issue has been resolved.

12 EFRAG TEG indicated that, before expressing a final view, the final wording of the criteria in assessing whether and investment return exists is needed.

13 **9 EFRAG TEG members** agreed with the tentative decisions of the IASB, including the decision taken in May.

14 **2 EFRAG TEG members** did not explicitly express a view.

15 One of the EFRAG TEG members that was absent from the meeting provided subsequently written inputs agreeing with the tentative decisions of the IASB.

Summary of EFRAG TEG discussion – April 2019

16 On the topic of CSM amortisation:

(a) EFRAG TEG members discussed different types of annuity contracts and considered the presence of an investment service component in such contracts.

(b) EFRAG TEG members were of view that, although the tentative decision of the IASB is a step in the right direction, the identification of investment services could be complex and requires judgement.

(c) Some members noted the importance of understanding the driver of CSM recognition.

(d) Some members assessed that for certain deferred annuities, even though annuity payments only commence after a certain accumulation phase, there are merits to consider some form of profit allocation during the accumulation phase.

Background information

EFRAG extensive case study

17 For ten of the twenty-six portfolios tested under the General Model, concerns were raised that investment services should be considered in CSM amortisation by seven respondents. One respondent calculated the CSM release based on insurance coverage of annuities and more than 60% of the CSM was released over years 25-30 of a 30-year annuity contract.

EFRAG simplified case study

18 Two respondents indicated that not including the investment services in the coverage units would bring profit recognition forward.

EFRAG user outreach

19 Nine specialist users noted that profit earned based on services provided was useful information to them. One user thought it was too early to tell. Of the ones that thought it was useful, the profit recognition pattern was considered more intuitive and made more sense than under current practices.

Question for EFRAG Board

20 Members are invited to note that EFRAG TEG in May 2019, agree with the IASB tentative decisions, subject to the final wording.

21 Based on the technical discussions presented above, what are your comments and orientation at this stage of the process?

Appendix 1 – Input from ANC and CFO Forum

Input from ANC

1 In ANC's view, the allocation period of the CSM should be extended to the longest period including the investment phase. The latter may be prior (i.e. annuities) or after (life insurance with accumulated benefits) the insurance phase.

2 A suggestion has been made by the ANC to define investment return services and extend the definition of the coverage period as follows. They have indicated that if there is no definition of investment return service, there could be a risk of limiting that feature to certain types of contracts.

IFRS 17.App A: ***coverage period****: The period during which the entity provides coverage for insured events and/or investment-return services. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.*

IFRS 17.App A: Investment-return service: is the service providing the policyholder with access to an investment return that would not otherwise be available to the policyholder because of the amounts invested, liquidity, complexity and expertise.

IFRS 17.B119: An amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)).

The amount is determined by:

(a) identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage for insured events and/or of investment-return services 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 period ~~duration~~.

Input from CFO Forum

3 In the CFO Forum's view, CSM amortisation should reflect insurance and investment activity, including related activities performed to deliver the insurance benefits.

4 The CFO Forum's proposed solution is to expand the 'coverage units' to include more than only insurance benefits. This is achieved by adding the proposed wording which would permit coverage units to include "related activities performed to deliver those benefits". This is intended to cover key non-insurance benefits such as investment activities. In order to narrow the scope of "related activities" two criteria were added:

(a) that are required to be performed by law or regulation; or

(b) that were assumed in the pricing of the contract, and performance or non-performance of those activities would have had a significant impact on either the premium charged or benefits offered under the contract.

5 The suggested wording changes made by the CFO Forum are as follows:

"B119 An amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided

under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)).

The amount is determined by:

(a) *identifying the coverage units in the group. 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 both the quantity of the benefits provided and the related activities performed to deliver those benefits under a contract and its expected coverage duration. Related activities performed to deliver benefits are those:*

(i) *that are required to be performed by law or regulation; or*

(ii) *that were assumed in the pricing of the contract, and performance or non-performance of those activities would have had a significant impact on either the premium charged or benefits offered under the contract.*

Appendix A

coverage period *The period during which the entity provides coverage for insured events or investment related services. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.*

Basis of conclusions

BC 279 As discussed in paragraph BC21, the Board views the contractual service margin as depicting the unearned profit for coverage and other services provided over the coverage period. Insurance coverage is often the defining service provided by insurance contracts but may not be the sole driver in all cases, for example where there are significant activities performed by the entity to deliver those services or where the contract includes an investment related service. The Board noted that an entity provides this service over the whole of the coverage period, and not just when it incurs a claim. Consequently, IFRS 17 requires the contractual service margin to be recognised over the coverage period in a pattern that reflects the provision of services, including both the contractual benefits ~~coverage~~ and the activities performed to deliver those benefits ~~as~~ required by the contract. To achieve this, the contractual service margin for a group of insurance contracts remaining (before any allocation) at the end of the reporting period is allocated over the coverage provided in the current period and expected remaining future coverage, on the basis of coverage units, reflecting the expected duration, ~~and~~ quantity of benefits provided and the activities performed to deliver the benefits ~~by~~ of the contracts in the group. The Board considered whether:

(a) the contractual service margin should be allocated based on the pattern of expected cash flows or on the change in the risk adjustment for non-financial risk caused by the release of risk. However, the Board decided the pattern of expected cash flows and the release of the risk adjustment for non-financial risk are not relevant factors in determining the satisfaction of the performance obligation of the entity. They are already included in the measurement of the fulfilment cash flows and do not need to be considered in the allocation of the contractual service margin. Hence, the Board concluded that coverage units better reflect the provision of ~~insurance~~ coverage."

Appendix 2 - Results of the Questionnaire to EFRAG IAWG on CSM amortisation patterns under the general model (prior to the May 2019 IASB tentative decisions)

Number of respondents

CSM amortisation
4

Part I: CSM amortisation under the general model

Changes to IFRS 17 (before the May 2019 IASB tentative decisions) do not lead to useful information for:

1 The following contracts were named:

(a) UK deferred annuities;

(b) Spanish Actuarial annuities; and

(c) Spanish Actuarial capital.

Description of insurance coverage

UK deferred annuities

2 Protection against longevity risk of policyholder (annuity is payable from date of retirement to death of policyholder). The policyholder is insured against their continued survival. The contracts may also include some life cover. Death of policyholder results in lower expected payments than survival.

Spanish Actuarial annuities

3 Deferred life annuity, constant or variable, with the periodicity defined at the time from the start the contract?. These annuities are only paid if the insured person survive during the accumulation period and it will only be paid while the insured person lives. There are no payments on death in these products.

Spanish Actuarial capital

4 Deferred Capital during the term agreed (accumulation period) that the insured person will receive in case of staying alive. There are no payments on death in these products.

Description of cash flows in the products

UK deferred annuities

5 Single premium at inception of the contract. An annuity is paid from date of retirement to date of death. At retirement of the policyholder a lump sum is paid out. Investment management expenses and administrative expenses incurred throughout full term of the contract. There is a transfer value during deferral period, at the option of the policyholder. Finally there are additional cash flows that may occur depending on terms of the deferred annuity:

(a) Annuity payments from date of death of policyholder (if post-retirement) to end of guarantee period. May be commuted to a lump sum.

(b) Lump sum death benefit on death of policyholder (if during deferral period).

(c) Dependant's pension payable from date of policyholder's death (at any time) to death of dependant (or reaching of a certain age if a child's pension).

Spanish Actuarial annuities and Capital

6 Survival cash flows (as capital or annuity).

Description of services provided by the products

UK deferred annuities

7 An insurance service is provided, protecting the policyholder against longevity risk. The contracts also include an investment service: investment risk is transferred from the policyholder to the insurer.

8 The benefits promised to the policyholder at inception are priced assuming an investment return that the insurer can achieve on investment of the initial premium, including an amount of illiquid assets that are not available to the policyholder for direct investment. The pricing of the contract will also include compensation to the insurer for providing the investment service and taking on the financial risks. The amount that would be repayable to the policyholder on transfer during the deferral period is expected to increase over time, reflecting an investment return.

Spanish Actuarial annuities and Capital

9 In both products, the entity provide the policyholder with access to an investment return that would not otherwise be available to the policyholder because of the amounts invested, liquidity, complexity and expertise.

Description of investment components in the products

UK deferred annuities

10 An investment component will only exist where there is an amount that is payable in all circumstances. Therefore for these contracts there will be an investment component, being the lowest amount, if all of the following exist in the contract:

(a) An amount payable on surrender/transfer during the deferral period;

(b) A death benefit payable during the deferral period; and

(c) A guarantee period during which the annuity will continue to be paid after death of the policyholder.

11 The existence of an investment component will depend upon the specific terms of the contract and may not be present in all contracts. As many of the UK deferred annuities arise from bulk purchase annuities (buy out or buy in to a defined benefit pension scheme) the contracts reflect the specific terms of the original occupational pension scheme, which can differ greatly.

Spanish Actuarial annuities and Capital

12 There is no investment component because there is no amount that the insured receives in any case. Because these products do not have an investment component, the release of the CSM should be made based on the amount of benefits provided in the period, without taking into account the return on investment service and the period in which, although not providing benefits to the insured, this service is provided for the return of the investments made by the entity.

13 In both products there are two components within the benefits provided to the policyholder: the actuarial component, for which the policyholder receives a greater benefit than in annuities and deferred capitals that have a payment for death, and the financial component derived from the guaranteed return to policyholder throughout the life of the policy. The release pattern of the CSM should reflect both components.

CSM recognition pattern using IFRS 17 and as viewed by respondents

UK deferred annuities

14 *In accordance with IFRS 17*, assuming the contract either contains an insignificant or no investment component (e.g. because of a minimal death benefit in deferral), the CSM recognition pattern will depend on other interpretations. A basic interpretation that bases the CSM recognition on the annuity payments payable in each period would result in virtually no CSM being recognised during the deferral period. CSM would be recognised from the date of retirement to the date of death.

15 *In the view of the respondent*, recognition of the CSM throughout the term of a deferred annuity, including the deferral period whether an investment component exists or not, would provide more useful information. A pattern based on the value of expected future annuity benefits would also be an appropriate reflection of both:

(a) The insurance coverage being provided from inception (protection against longevity); and

(b) The investment service that is provided to produce those future benefits and that is reflected in the transfer value (typically this is also based on the expected future benefits, considering expected investment returns).

Spanish Actuarial annuities and Capital

16 *In the view of the respondent* the use of the present value of the future mathematical provisions at pricing conditions made at inception is the most appropriate unit of coverage because it includes the calculation basis for the estimation of the interests of the insurance liabilities.

Supporting assets and investment return/yield assigned to the liabilities

UK deferred annuities

17 Deferred annuities are usually backed by fixed income investments, such as gilts, corporate bonds and illiquid assets such as commercial mortgages and infrastructure loans. All would be carried at fair value under IAS 39/IFRS 9.

18 If there is close matching the return on assets recorded in accordance with IFRS 9 would offset with the insurance finance expense recognised due to the effects of discounting on the IFRS 17 liabilities. There would be no direct link between the CSM recognition and investment return.

19 The amount of CSM recognised would instead reflect the part of the initial premium that the insurer requires as compensation for providing the investment return service and would be recognised over the period in which that service is provided.

Spanish Actuarial annuities and Capital

20 The insurance contracts that are within these two products are economically matched and have specific backing portfolios of debt instruments supporting the cash flows to be paid to policyholders. The accounting treatment of these assets will be done under IFRS17 (FVOCI).

21 The entity earns a constant financial margin that is the difference between the internal rate of return of financial assets and the guaranteed interest rate. Because the entity will use the asset rate (eliminating the corresponding spreads) in the initial recognition, the CSM will include the financial margin obtained by the entity.

General answer received

22 For the Belgian branch 21 Modern Life products with discretionary profit sharing (full discretion in Belgium) the general model is being applied. The proposed amendments are a solution for the fact that under the general model there are

contracts where not only insurance services are provided by the insurer but also investment services and both types of services should be reflected in the CSM release over the duration of the contracts.