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IFRS 17 Variable Fee Approach

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After a very long journey, the International Accounting Standards Board (IASB) issued IFRS 17 Insurance Contracts (IFRS 17). IFRS 17 replaces IFRS 4 that was issued in 2004. The overall objective is to provide a more useful and consistent accounting model for insurance contracts among entities issuing insurance contracts globally.

GENERAL MODEL AND VARIABLE FEE APPROACH

The IASB introduces a general accounting model (GM, previously called building-block-approach) for the insurance contract liability measurement.¹ In order to cater to the unique features of insurance contracts with direct participation features, IFRS 17 provides for a specific approach called the variable fee approach (VFA). Insurance contracts with direct participation features (or “direct participating contracts”) are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying



items. These may be regarded as creating an obligation to pay policyholders an amount that is equal to the fair value of the underlying items, less a variable fee for service.

VFA is a modification of GM in order to reflect the nature and economics of these direct participating contracts. Table 1 summarizes the key differences between GM and VFA.

Table 1
Differences between GM and VFA

Measurement model	Changes in fulfilment cash flows (FCF) due to the changes in financial variables	Insurance finance income or expenses
GM	All changes in discount rates and other financial variables are reported in the statement of comprehensive income	The interest expenses on the contractual service margin (CSM) are explicitly accreted using rates at the initial recognition of the contracts
VFA	CSM is adjusted to reflect the changes in the variable fee, which includes some changes in discount rates and other financial variables	The interest expenses are implicit in the changes in the insurer’s variable fee

VFA ELIGIBILITY CRITERIA

The IASB made it clear that only insurance contracts with direct participation features are eligible for the VFA, but significant judgment is required to assess the VFA eligibility, as outlined in paragraph B101 and BC238.

Insurance contracts with direct participation features are insurance contracts for which, on inception:

- the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items; (VFA criteria I)
- the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns from the underlying items; (VFA criteria II) and
- 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. (VFA criteria III)

KEY CONSIDERATIONS FOR LIFE INSURERS

With the significant judgment required for the VFA eligibility assessment, we expect these to be part of the key issues to be discussed by the Transition Resource Group (TRG). Below are some evolving questions we observed from the market.

1. What is a clearly identified pool of underlying items?

The pool of 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, as long as they are clearly identified by the contract. An entity need not hold the identified pool of underlying items because the measurement of insurance contracts should not depend on what assets the entity holds. The underlying items do not need to be a portfolio of financial assets. They can comprise items such as the net assets of the entity or a subsidiary within the group that is the reporting entity.

2. What is the definition of “contract” and “contractual terms” when defining the clearly identified pool of assets?

A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity’s customary business practices. Contractual terms include all terms in a contract, explicit or implied. Implied terms in a contract include those imposed by law or regulation.

There are certain features which may not satisfy VFA criteria I: (i) different portfolios of participating contracts (direct or indirect) share the same fund with notionally separated assets in the entity’s general account, and (ii) the segregation of assets are only managed internally without enforceability or proper disclosure to the policyholders. While “ring-fenced-asset” may better meet this criterion, there are also discussions if the “accounting designation” or “entity’s governance framework and disclosure” meet this criterion. Advocates argue that commercial communication, i.e., materials presented or disclosed to the policyholders, can form part of the enforceability and the entity should consider these factors for the assessment of clearly identified pool of assets. In any case, the definition of the “underlying items” should be documented clearly, and the entity cannot change the underlying items with retrospective effects.

3. Does “a share of a clearly identified pool of underlying items” preclude the entity’s discretion to vary the amounts paid to the policyholder?

No, but the link to the underlying items must be enforceable.

4. How to interpret the word “substantial” in VFA criteria II and III?

The IASB made it clear that only insurance contracts with direct participation features are eligible for the variable fee approach, but significant judgment is required to assess the VFA eligibility.

The IASB does not provide a concrete definition for the term “substantial” as noted in the VFA criteria II and III. This is to allow entities to apply IFRS 17 for their particular circumstances without being limited by any quantitative rules. We expect that market consensus will converge with potential help from TRG discussion. However, a range of sharing percentages may still be expected from various jurisdictions due to different product offerings, and comparability with the fee structures of the investment products offered. An individual entity needs to perform its own assessment, and verify its conclusion with its respective auditor.

5. What is the “variable fee”?

A variable fee that the entity will deduct in exchange for the future service provided by the insurance contract, comprises: (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. Contracts eligible for VFA should specify a determinable fee which can be expressed as a percentage of portfolio returns or asset values rather than only as a monetary amount. Without a determinable fee, the share of returns on the underlying items the entity retains would be entirely at the discretion of the entity, and this would not be consistent with that amount being equivalent to a fee.

ILLUSTRATIVE EXAMPLE

A simple five-year investment-linked product is created to illustrate the CSM differences between VFA and GM, with the projection given in Table 2:

- Death benefit (sum assured) = fixed 500 + account value (AV),
- maturity benefit = AV,
- level annual premium = 500,
- 2 percent asset management charge (AMC),
- cost of insurance charge (COI charge) and
- 100 identical policies issued.

Table 2
Assumed projected cash flows and AV

Projected best estimate cash flows (BECFs) for 100 policies at inception						
BE projection/Year	Yr1	Yr2	Yr3	Yr4	Yr5	Yr6
No. survival(BOY)	100	99	97	94	90	85
No. deaths(EOY)	1	2	3	4	5	
No. survival(EOY)	99	97	94	90	85	
Premium(BOY)	50,000	49,500	48,500	47,000	45,000	-
Commission(BOY)	5,000	2,475	970	-	-	-
Expense(BOY)	200	198	194	188	180	-
Death outgo(EOY)	1,000	3,030	6,186	10,638	16,667	-
Survival outgo(BOY)	-	-	-	-	-	240,833
Net CF	43,800	43,797	41,150	36,174	28,153	(240,833)
Projected policyholder AV (PHAV) for 100 policies at inception						
PHAV(BOY)	-	49,500	98,470	146,814	194,362	
Premium(BOY)	50,000	49,500	48,500	47,000	45,000	
COI charge(BOY)	(500)	(1,000)	(1,500)	(2,000)	(2,500)	
Investment income(EOY)	1,490	4,460	8,940	15,022	22,876	
AMC(EOY)	(990)	(1,960)	(2,909)	(3,836)	(4,737)	
Death outgo from PHAV(EOY)	(500)	(2,030)	(4,686)	(8,638)	(14,167)	
PHAV(EOY)	49,500	98,470	146,814	194,362	240,833	

Table 3 summarizes the key steps in calculating the initial and subsequent CSM under GM as follows:

1. FCF and initial CSM are the same under both GM and VFA. In this example, the cash flows for the FCF calculation are based on the BECFs with the following assumptions: (i) directly attributable expenses = 100% BE expenses, and (ii) investment component = death and survival outgo supported by PHAV.
2. FCF is the PV of the risk adjusted cash flows which includes best estimate liability (BEL) and risk adjustment (RA). The discount rate (initial DR) is assumed to be the PHAV growth rate (which in this example is the risk-free yield curve).

Initial CSM is the unearned profit at inception and is equal to the negative of FCF floored by zero. For simplicity, RA is assumed to be zero.

3. 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. In this example, it is assumed to be **the number of policy in force * sum assured (including AV)**.
4. The BOY CSM is accreted with interest (at initial DR), and then amortized according to the coverage unit pattern.

Table 3
CSM under GM

Step (1): CFs for FCF calculation						
	Inception	Yr1	Yr2	Yr3	Yr4	Yr5
Premium	50,000	49,500	48,500	47,000	45,000	-
Commission & Expense	(5,200)	(2,673)	(1,164)	(188)	(180)	-
Survival outgo	-	-	-	-	-	(240,833)
Death(ins component)	-	(500)	(1,000)	(1,500)	(2,000)	(2,500)
Death(inv component)	-	(500)	(2,030)	(4,686)	(8,638)	(14,167)
Net CF (NCF)	44,800	45,827	44,306	40,626	34,182	(257,500)
Step (2): FCF calculation						
BEL	(3,200)					
RA	-					
FCF	(3,200)					
Step (3): Coverage unit						
NOP		100	99	97	94	90
SA		1,000.0	1,515.2	2,061.9	2,659.6	3,333.3
Coverage unit		100,000	150,000	200,000	250,000	300,000
Step (4): CSM under GM						
CSM(BOY)		3,200	2,913	2,472	1,858	1,047
Interest accretion		96	133	152	146	101
Amortization		(383)	(574)	(765)	(957)	(1,148)
CSM(EOY)		2,913	2,472	1,858	1,047	-

Table 4 summarizes the key steps in calculating the initial and subsequent CSM under VFA as follows:

5. The variable fee that the entity will deduct from fair value of the underlying items in exchange for the future service provided, comprises: (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.
 - a. The entity's share of the fair value of the underlying items is assumed to be the cash flows paid to the entity including the COI charge and AMC. The initial balance as of inception is the present value of the related cash flows (at initial DR). The beginning of year balance is accreted with interest (at initial DR), and then adjusted by the amount paid to the entity.
 - b. FCF that do not vary based on the return on underlying items are assumed to be the cash flows paid by the entity including the commission, expenses and death outgo (insurance component). The initial balance as of inception is the present value of the related cash flows (at initial DR). The beginning of year balance is accreted with interest (at initial DR), and then adjusted by the amount paid by the entity.
6. The initial CSM is the same under VFA and GM. Figure 1 illustrates that the emerging patterns of CSM are different between the two models. CSM is amortized according to the coverage unit pattern under GM while it is affected by the fair value of the underlying items and the cash flows paid to or by the entity under VFA. The CSM amortization approach under VFA is the same as the one under GM.

Table 4
CSM under VFA

Step (5)(a): Entity's share of the fair value of the underlying items (ES of UI)						
	Inception	Yr1	Yr2	Yr3	Yr4	Yr5
BOY	18,584	18,084	16,638	13,935	9,882	4,320
Paid to entity(BOY)	(500)	-	-	-	-	-
Change in ES of UI		544	757	856	774	417
Paid to entity(EOY)		(1,990)	(3,460)	(4,909)	(6,336)	(4,737)
EOY	18,084	16,638	13,935	9,882	4,320	-
Step (5)(b): FCF that do not vary based on the return on underlying items (FCF non UI)						
BOY	15,384	10,184	7,318	5,487	4,136	2,280
Paid by entity(BOY)	(5,200)	-	-	-	-	-
Change in FCF non UI		307	333	337	324	220
Paid by entity(EOY)		(3,173)	(2,164)	(1,688)	(2,180)	(2,500)
EOY	10,184	7,318	5,487	4,136	2,280	-
Step (6): CSM under VFA						
CSM(BOY)		3,200	3,038	2,810	2,358	1,467
Change in ES of UI		544	757	856	774	417
Change in FCF non UI		(307)	(333)	(337)	(324)	(220)
Amortization		(399)	(653)	(971)	(1,341)	(1,664)
CSM(EOY)		3,038	2,810	2,358	1,467	-

Figure 1
Comparison of the CSM balance between VFA and GM



CONCLUSION

There are a number of factors that require the entity's judgment for the VFA eligibility assessment. Different assessment outcomes may result in a similar product sold by two insurers because of different management frameworks. Similarly, two products with similar economic nature (written by an insurer) may fall into different measurement models because of the contractual terms. All these may impact the comparability of results across the industry or within the same entity.

Similar to the Solvency II experience, it is expected that certain market consensus will converge for these judgmental areas. The assessment for certain products may be easier than others, depending on the complexity of the product features. The methodology and assessment should be properly documented and approved within the entity's governance structure, and agreed with the entity's auditor. It is also important for individual entities to understand both the financial and operational impacts of using different measurement models at the beginning of the implementation journey. ■

The views reflected in this article are the views of the authors and do not necessarily reflect the views of the global EY organization or its member firms.



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ENDNOTE

¹ Please refer to EY's Insurance Accounting Alert (May 2017) for an IFRS 17 overview; [http://www.ey.com/Publication/vwLUAssets/Insurance_Accounting_Alert_May_2017/\\$FILE/ey-insurance-accounting-alert-may-2017.pdf](http://www.ey.com/Publication/vwLUAssets/Insurance_Accounting_Alert_May_2017/$FILE/ey-insurance-accounting-alert-may-2017.pdf)