IFRS 17 *Insurance Contracts* – Fair value calculation at transition
Issues Paper

Objective and general introduction

1 The objective of this paper is to describe the input received from two case study participants how they have calculated the fair value of portfolios of insurance liabilities in applying the fair value transition approach in accordance with IFRS 17.

2 The EFRAG Secretariat has contacted two participants of the extensive case study in order to receive more detailed information on the reasons why the CSM calculated in a fair value approach was generally found to be too low. This paper reflects the inputs received. For confidentiality reasons, quantitative information that directly relates to portfolios used for the case study has been omitted.

Input received from participant 1

3 "*This [chapter] compares the Fully Retrospective Approach (FRA) and Fair Value (FV) approach to transition under IFRS 17. We describe the factors that drive the calculation of the CSM on transition under each approach. We conclude that the two approaches are conceptually very different and that, consequently, it is reasonable to expect that the CSM under each approach will be different.*

Fully Retrospective Approach

4 *Under the FRA the CSM at transition is determined as if IFRS 17 had always applied. The CSM is therefore determined at the date of initial recognition of the in-force contracts and rolled forward to the date of transition. The size of the CSM at initial recognition is driven by the premium charged to the policyholder which is impacted by a number of factors, including:*

(a) *The level of competition between insurance companies in the particular territory concerned,*

(b) *The demand for the insurance product amongst consumers, which can be impacted inter alia by regulation, degree of insurance penetration in the market concerned, sophistication of investors, etc.*

5 *The size of the CSM at transition is further impacted by the required adjustments on remeasurement set out in the standard and the amount recognised in P&L to reflect the transfer of services under the contracts.*

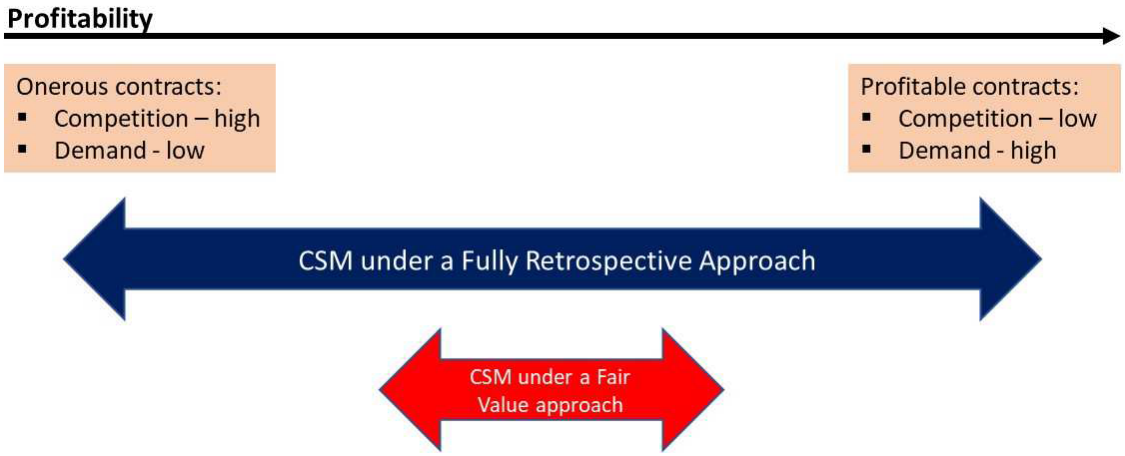
6 *In practice there is a wide variation in the profitability of insurance business, ranging from highly profitable business in markets where there is limited competition between insurers and/or low levels of insurance penetration, to less profitable and potentially onerous business in markets where there is much greater competition and higher levels of penetration. This translates to a wide range of CSMs under a FRA, driven by the relationship between the insurance company and the consumer.*

Fair Value Approach

7 *Under the FV approach the fair value of liabilities at the date of transition is defined (in accordance with IFRS 13) as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants". The CSM at transition is then the fair value of the liabilities less their fulfilment value (IFRS 17 best estimate liability plus risk adjustment).*

8 *A fair value is therefore driven by the relationship between two willing market participants and is determined by reference to the rate of return required by such market participants, which is entirely separate from the pricing dynamic between the insurance company and its policyholders. Market participants will generally be large financial institutions who have a broad choice of financial investments available to them. Investment in, or divestiture of a portfolio of insurance contracts would be assessed in this context.*

9 *The range of fair values is likely to be much narrower than under the FRA, with a buyer unlikely to take on business on onerous terms and a seller being unlikely to sell business on terms that are too attractive to a buyer. Thus the CSM on a fair value basis is likely to be higher than under a FRA in many circumstances and lower than under a FRA in many other circumstances. This is illustrated in the following diagram."*



Additional information by the EFRAG Secretariat

10 In a conference call with the participant, the EFRAG Secretariat noted also the following information:

11 It was acknowledged that the CSM is not always low when applying fair value, but rather that a range of CSM-profitabilities existed (however comprised within the above indicated limited range, which indicates a lower CSM compared to applying the MRA approach). It was very difficult to identify the drivers that led to a low CSM as transactions that are available on the market are driven by many factors. The participant provided the following examples of CSM calculation under the fair value approach:

12 *Example 1*: Assume a European portfolio of participating insurance contracts, funded by European bonds. In Europe, interest rates have generally moved lower over the last years. As a result the cost of the guarantees has increased, driving CSM down in a full retrospective approach. This would result in a high CSM applying the fair value approach.

13 *Example 2*: Assume a portfolio of participating insurance contracts funded by equities. Equities have generally been rising over the last years. As a result this would result in a high CSM applying the retrospective approach and a low CSM applying the fair value approach.

14 The causality between a high CSM under the full retrospective approach and a low CSM using the fair value approach (and vice versa) is explained by the information received from participant 2.

Input received from participant 2

15 This case study participant illustrated the topic with the following hypothetical example.

CU	IFRS 17FCFs	FVA	MRA
Fund assets	**1,000**	**1,000**	**1,000**
Unit liability (fair value of underlying assets)	(1,000)	(1,000)	(1,000)
Present value future profits (variable fee)	50	50	50
Risk adjustment	(10)	(10)	(10)
IFRS 17 FCF	**(960)**	**(960)**	**(960)**
CSM		**(8)**	**(30)**
IFRS 17 LRC		**(968)**	**(990)**
Shareholder equity		**(32)**	**(10)**

16 During the conference call with the case study participant it was noted that the above calculation was agreed upon with the advisor of the preparer.

Key messages:

17 VFA – for VFA there is a key systematic methodology difference between MRA and FVA which means that a greater proportion of transition date VIF is recognised in opening CSM under the MRA approach.

18 GM – for GM systematic differences are less pervasive. However, for certain business lines FVA gives a lower CSM because (a) MRA captures value from assumption changes which have reduced Best Estimate Liability BEL since business was written (recent longevity weakening for particular annuities) and (b) MRA captures higher margins from individual product sales whereas FVA margins reflect lower margins achieved on bulk portfolio level transactions.

FVA CSM

19 In order to take on liabilities an acquirer would require:

(a) *[The seller] to give them the fund assets of 1,000 which back the unit liability;*

(b) *They would typically give [the seller] value for 70%-90% of value in force (Value in Force VIF = Present Value of Future Profits PVFP - risk adjustment). If we assume 80% = 80% * (50-10) = 32*

20 Therefore, fair value of liabilities = 1000-32 = CU968m.

21 CSM = Fair value of liabilities less IFRS 17 FCFs (CU968m – CU960m = CU8m)

22 Key point – CSM reflects a fair valuation of the IFRS 17 FCFs and not a fair valuation of the Shareholder VIF. Therefore, CSM only captures relatively small proportion of transition date VIF (10-30%).

MRA CSM

23 MRA starting point for CSM calculation is fair value of underlying items less IFRS 17 FCFs at transition date. This gives a starting point for CSM calculation of CU40m (CU1,000m - CU960m) which is the value in force (VIF) at the transition date.

24 *This starting VIF should then be rolled back using actual historic annual management charges (AMCs), administration and acquisition costs to get inception date CSM. Inception date CSM then released using pattern of services to get CSM at transition.*

25 *Assuming AMC's and administration expenses arise evenly through the contract life and services are provided evenly over contract life then likely to end up with result which is close to the transition date VIF less the value of deferred acquisition costs at that date. If we assume DAC at transition of CU10m this gives CU1,000m - CU960m - CU10m = CU30m.*

Questions asked by the EFRAG Secretariat

26 **Question 1: The example is built on selling underlying assets *and* liabilities. Do you have an example of liabilities in isolation? Does this happen in practice?**

27 *For the majority of our VFA business the policyholder liabilities are contractually linked to specific pools of segregated assets. As such it is difficult to divorce the asset pools from the liabilities and therefore an acquirer of the liabilities will typically also acquire the assets.*

28 *However, if you did want to remove the assets backing the policyholder liabilities it would not in our opinion change the CSM generated. Using the figures in our example the question would be what would you have to pay someone to take on the liabilities of CU960 which are comprised of (a) a unit liability based on the fair value of segregated assets supporting the business of CU1000 less (b) a value in force based on entity's expectation of future profits arising from the business of CU40? The table below summarises the position if you exclude the assets:*

Element of policyholder liabilities	IFRS 17 term	IFRS 17 Fulfilment cash flows	Compensation required to take on liabilities	Difference = CSM	Comment
Unit liability based on fair value of segregated asset pool	The obligation to pay the policyholder the fair value of underlying items	1,000	1,000	0	Fulfilment cash flows for this element of IFRS 17 BEL already measured at fair value so no difference expected between compensation and IFRS 17 FCFs.
Value in-force based on entity's expectation of future profits arising from the business	Variable fee	(40)	(32)	8	Compensation based on industry experience is that the acquirer pays for 70-90% of the VIF. In this case we assume 80% (40 x 80% = 32).
		960	968	8	

29 **Question 2: Does remaining duration of the liabilities have a (significant) influence on the fair value?**

30 Question still under investigation but the expectation is that the longer the duration of the liabilities the more risk there would be that unfavourable lapse assumption changes would negatively impact the future profits and therefore you would expect an acquirer to pay less for a given amount of future profits. To the extent that the VIF incorporates a measurement of non-financial risk the increased lapse risk for longer durations may already be factored into the measurement of the VIF.

Question to EFRAG TEG

31 Do EFRAG TEG have comments on the way CSM is calculated under the fair value approach? Please explain why.

32 Do EFRAG TEG have other observations on the findings illustrated in this paper?