CSM: use of locked-in or current discount rate
Issues paper

Objective

1 The objective of this session is to discuss a paper submitted by an EFRAG IAWG member about the impact of the use of a locked-in discount rate for the contractual service margin ('CSM').

Description of the issue

2 Paper 05-04B, as submitted by an EFRAG IAWG member, notes that under the general requirements of IFRS 17 *Insurance Contracts* an inconsistency occurs between the measurement of the CSM and the measurement of the fulfilment cash flows. That inconsistency is created by the fact that the CSM is accreted at a locked-in rate, while the fulfilment cash flows are measured on a current basis.

3 Paper 05-04B argues that the inconsistency creates inappropriate volatility in total comprehensive income ('TCI') and shareholder equity. Hence, the paper proposes to calculate the CSM based on current rates instead of on a locked-in rate. It is argued that the issue is material as it applies in all cases where the fulfilment cash flows are an asset.

4 These papers were discussed at the November 2017 EFRAG IAWG meeting and below is a summary of comments from EFRAG IAWG members.

EFRAG Secretariat analysis

Observations

5 The EFRAG Secretariat notes the following about the base scenario:

(a) The fulfilment cash flows are an asset;

(b) No coverage units have been defined, but appears to be one per year;

(c) The contracts demonstrate an increasing profit pattern, starting with a 2% margin (CU10 of CU500) in Y1, ending with a 20% margin (CU100 of CU500) in Y10; and

(d) Profit is front-loaded[1] by allocation of an amount of CU47[2] annually from CSM to TCI and subsequently equity.

6 The EFRAG Secretariat notes the following about scenarios 2 and 3:

(a) In scenario 3, the change in discount rates for both the CSM and the fulfilment cash flows are taken to other comprehensive income ('OCI'), resulting in a net balance of CU17[3] in Y2. This represents the change in the fulfilment cash flows of CU47, offset by an amount of CU30 change to the CSM, both due to the rate change. That amount is reversed over the remaining duration of the contracts.

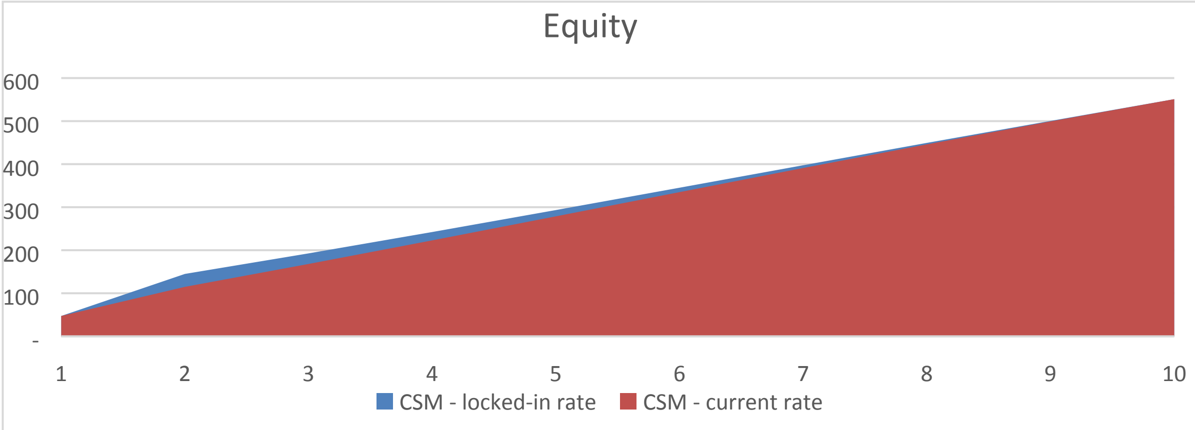
[1] In accordance with IFRS 17 paragraph IE 17(e)

[2] Calculated as: (CU290+CU29)/(1+1/(1+10%)+1/(1+10%)^2+…1/(1+10%)^9)

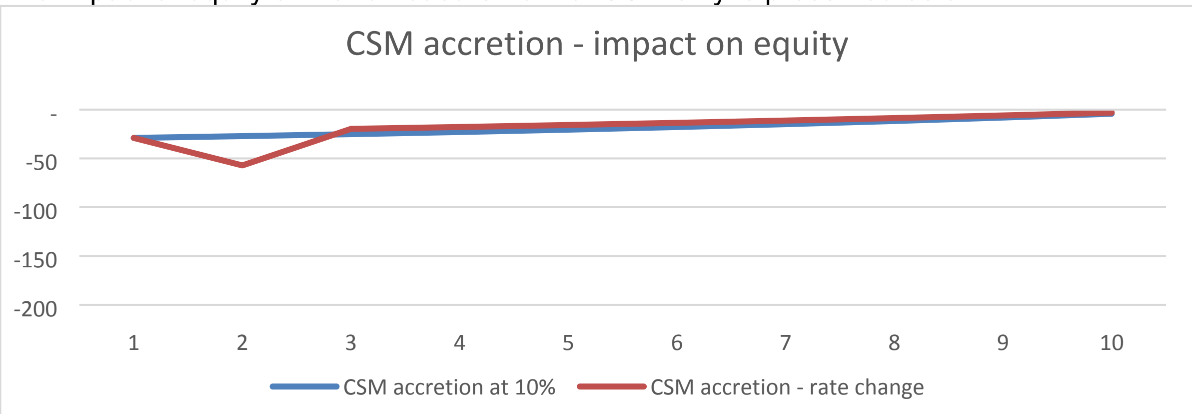
[3] Calculated as: in Y2- current liabilities (CU367-CU282) = CU85 – locked-in liabilities (CU320 – CU252) = CU68; overall difference is CU17. To achieve this outcome, the CSM is treated similarly as the fulfilment cash flows.

(b) The example treats the annual CSM allocation as future cash flows and these are not impacted by the rate change.

(c) The graphic presentation of the impact on equity of remeasuring both the fulfilment cash flows and CSM is presented below:



The impact of equity of the remeasurement of CSM only is presented below:



(d) The avoidance of volatility becomes more difficult at the end of the duration of the group of contracts, i.e. market rate changes later in the last year would have to be amortised (i.e. reversed) immediately;

(e) The volatility due to a rate change would be increased where both the fulfilment cash flows and CSM are liabilities, compared to the general model under IFRS 17; and

(f) Using the same facts, the EFRAG Secretariat expects the effects of a rate increase to result in an increase in equity that will reverse over time.

Further analysis

7 Under the assumption that the CSM is updated at current rates, *similarly to the treatment of the fulfilment cash flows*, questions arise such as:

(a) whether the allocation of CSM of CU47 (even when there is a change in discount rate) represents only insurance service result; and

(b) does an update of the CSM change its nature, i.e. should the total profit of the contract remain unchanged over time or does the total profit change?

Explanation in IFRS 17

8 IFRS 17 paragraph BC274 justifies the use of the locked-in rate on the basis that the CSM does not represent future cash flows. Instead, it represents the unearned profit in the contract, measured at the point of initial recognition and adjusted only for specified amounts.

9 Given that the CSM is not a cash flow (as is accepted by the IAWG member submitting the issue), it is not clear why the CSM should be remeasured based on current interest rates.

Summary of November 2017 EFRAG IAWG's comments

10 There was a discussion about the impact of accreting the CSM the rate at inception as required by IFRS 17 for the General Model and not using a current rate as for the best estimate liabilities. Proponents of using a current rate argue that using a locked-in rate for CSM and a current rate for the best estimate liability results in an accounting mismatch. This creates volatility in equity and OCI, notably when the fulfilment cash flows are in an asset position.

11 The EFRAG Secretariat explained that as the CSM is regarded as the unearned profit rather than a cash flow such a remeasurement is not appropriate. It was also questioned why the fulfilment cash flows and the CSM should match as described in the example and what implicit ALM practice is underlying the example.

12 Supporters for the remeasurement of the CSM at current rate also cite operational burdens from tracking the locked-in rate. From the discussion, it appeared that support was strongest from those territories where the GAAP applied under IFRS 4 *Insurance Contracts* uses a current rate to update liability estimates. The argument is that the storage and use of several rates for CSM is onerous whilst not providing relevant information. One EFRAG IAWG member commented that the CSM calculation does not necessarily have to form part of the actuarial calculation but could be done separately in the financial module.

13 One EFRAG IAWG member noted however that use of a current rate would alter the timing of CSM released into profit and loss result if the OCI option is not used to present the effects of changes in discount rate.

14 Supporters of the remeasurement of CSM would favour any changes to be mandatory for all insurance contracts rather than an additional option.

15 The EFRAG Secretariat explained that the next steps in considering this issue would include:

(a) discussion at EFRAG TEG;

(b) updating of the example to show the impact on insurance versus financial result and to consider the impact of the unlocking of the CSM; and

(c) updating the draft of Appendix 2 to the DEA as necessary following these discussions.

16 One EFRAG IAWG member also suggested that the EFRAG Secretariat should review papers on the topic prepared by the Australian and New Zealand standard setters during the development of IFRS 17.

Question for EFRAG TEG

17 Do EFRAG TEG members consider that the CSM should be remeasured using current interest rates? If so, please explain the basis for your view, including why changes in interest rates should affect the pattern of release of the CSM.