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Scope of the Variable Fee Approach Issues paper

Objective

- 1 The objective of this session is to provide an overview of the EFRAG Secretariat's understanding of the issues raised by EFRAG IAWG members in relation to the scope of the Variable Fee Approach ('VFA').
- 2 The outcome of the discussion is to make relevant changes to Appendix II of the endorsement advice of IFRS 17 *Insurance Contracts*.

Summary of the IFRS 17 requirements

- 3 Insurance contracts with direct participation features (i.e. those in the scope of the VFA) are insurance contracts for which:
 - (a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;
 - (b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and
 - (c) 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. [IFRS 17 paragraph B101]
- 4 Contracts can be written, oral or implied by an entity's customary business practices. [IFRS 17 paragraph 2] However, the link to the underlying items must be enforceable. [IFRS 17 paragraph B105] Enforceability of the rights and obligations in a contract is a matter of law. [IFRS 17 paragraph 2]

Description of the issues and EFRAG Secretariat analysis

Issue 1 – Extension of VFA scope to include contracts with a non-enforceable constructive obligation

- 5 Insurance contracts where there is a constructive obligation which is not enforceable are not eligible for the VFA¹. Therefore, it is argued that these contracts which are seen to be similar in nature and similar in terms of asset and liability management would be treated in different ways, thereby reducing comparability. For these contracts that cannot apply the VFA, there would be an increase in volatility in equity because changes in financial risk would go to comprehensive income instead of adjusting the contractual service margin ('CSM').

¹ For example, past business practices may reflect that a substantial share of the returns of the underlying items are paid to the policyholder, however, if this business practice is not enforceable, the contracts are not in scope of the VFA.

EFRAG Secretariat analysis on Issue 1

- 6 The key element relating to this issue is the enforceability of the constructive obligations of the insurer. The EFRAG Secretariat notes that for contracts to be in the scope of the VFA, the contractual terms must be enforceable and 'economic compulsion' should not be considered and this is consistent with other IFRS standards. The EFRAG Secretariat acknowledges that in some jurisdictions, contracts with constructive obligations are enforceable while they are not enforceable in other jurisdictions.
- 7 The EFRAG Secretariat agrees with the IFRS 17 requirements that the link to the underlying items needs to be enforceable because we consider that gains from the underlying items, for contracts within the scope of the VFA, are essentially for the policyholder. Therefore, enforceability enables the protection of the policyholder's rights. If the contractual terms are not enforceable, then the gains could be seen to be essentially for the insurer and the General Model covers these types of contracts.
- 8 The EFRAG Secretariat notes that the VFA reduces volatility in shareholders' equity because it eliminates accounting mismatches with the underlying items.

Issue 2 – Risk of strict interpretation of substantial proportion of changes in amounts to be paid to the policyholder vary with a change in fair value of the underlying items

- 9 There is a risk that a strict interpretation of the criteria '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' may cause certain contracts to be out of the scope of the VFA. This is because changes in amounts to be paid to the policyholder do not always vary directly with the change in fair value of the underlying items but may rather vary with the change of the realised return based on local GAAP accounting.
- 10 It was noted at the September 2017 EFRAG IAWG meeting that even if regulation defines a different pattern for the sharing of the returns on the underlying items, in the end, the fair value would be shared with the policyholders and so the contracts would be in scope of the VFA.
- 11 At the September 2017 EFRAG TEG meeting, some members indicated that the expectation of the variability would have to be assessed and considered over the whole contract duration and on a probability weighted basis over a number of scenarios. Therefore, in the short-term, there need not be a direct link between the change in payment amount and change in fair value of the underlying items, but the assessment had to be done for the whole duration of the group of contracts.

EFRAG Secretariat analysis on Issue 2

- 12 The EFRAG Secretariat agrees with the comments made in paragraphs 10 and 11 above. The EFRAG Secretariat understands that the assessments are made over the duration of the group of contracts (and not in the short-term) by looking at various scenarios over the whole duration of the contracts. Then after this assessment, if the contracts have a substantial proportion payable to the policyholders that vary with the change in fair value of the underlying items, these would be in scope of the VFA.

Questions for EFRAG TEG

- 13 Does EFRAG TEG agree with the EFRAG Secretariat's analysis on both issues? Please explain.
- 14 Does EFRAG TEG have any other comments? Please explain.