EFRAG
European Financial Reporting Advisory Group

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Insurance team

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Changes to paragraph B107 of IFRS 17
Issues Paper

Objective

1 The objective of this session is to consider:

(a) The technical impact of the February decision by the IASB to amend paragraph B107; and

(b) The operational impact if any of the above decision.

Background

2 At its February 2020 meeting, the IASB approved the following change to paragraph B 107 as proposed in the 2019 ED:

"B107 Paragraph B101(b) requires that the entity expects a substantial share of the fair value returns on the underlying items will be paid to the policyholder and paragraph B101(c) requires that 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. An entity shall:

(a) ...

(b) assess the variability in the amounts in paragraphs B101(b) and B101(c):

(i) over the duration of the ~~group of~~ insurance contract~~s~~; and

(ii) on a present value probability-weighted average basis, not a best or worst outcome basis."

3 In Appendix 3 of its comment letter EFRAG stated the following: "*EFRAG has been informed by its constituents that there are concerns with the assessment being done at individual contract level rather than at groups of contracts as this would be inconsistent with the unit of account for IFRS 17 measurement and would unduly disrupt the implementation projects and therefore significantly increase costs.*"

Other relevant references in IFRS 17

4 Paragraph B38 notes that: "*The starting point for an estimate of the cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome to derive an expected present value. Consequently, the objective is not to develop a most likely outcome, or a more-likely-than-not outcome, for future cash flows.*"

5 Contracts that qualify for the VFA are described as follows in paragraph B101: "*[i] Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items.*"

EFRAG Secretariat analysis

6 The EFRAG Secretariat notes that the IASB has made it clear that whilst insurance contracts under the VFA will contain significant insurance risk as per the definitions of the standard, the focus of such contracts is investment returns rather than insurance coverage. This is the reason for a separate measurement model and other concessions such as the use of the current period book yield approach.

7 Furthermore, in the description of the estimation of fulfilment cash flows, probability of the insured event happening is taken into consideration. The *assessment at inception* of what model a contract should be accounted for is not revisited subsequently.

8 For example, where there is a contract with direct participating features including an insured event such as death, under most circumstances, the probability of the insured event occurring will be relatively low and so unlikely to have a significant impact on the variability of the cash flows paid to the policyholder (either based on returns or changes in fair value).

9 Where this is not the case, i.e. at *inception* of a life insurance contract with an older person who is more likely to claim compared to a younger one, one of three things may occur:

(a) The premiums under the contract may be significantly increased;

(b) The pay-out amount under the insured event may be significantly reduced; or

(c) The age of the person is not considered in the setting of the price and related cash flows.

10 In the unlikely event that scenario (c) above prevails, it is possible that the cash flows under the contract are dominated by the cash flows arising from the insured event rather than being substantially an investment-related service. In such a case, there is no conceptual reason why such a contract should qualify for the accounting under the VFA.

11 Where scenarios (a) or (b) prevail, it depends on the pricing, but for those contracts where the intention is to provide an investment-related service, it is likely that the variability in the cash flows will be more heavily impacted by changes in the underlying items rather than the insured event based on an average assessment of the probability of various scenarios. That is, an entity would determine a probability weighted average of the fulfilment cash flows. It would then look at the different scenarios and check how much of the possible changes in cash flows (compared to the probability weighted average) are driven by fair value changes or by changes due to the insured event. If the entity expects that there would be a lot of the variability coming from the changes due to the insured event, these contracts would not be able to apply the variable fee approach.

12 The EFRAG Secretariat notes that whilst the level of aggregation requirements are relevant for the recognition, measurement and disclosures of populations of contracts, the identification of a contract as an insurance contract is done taking into account the characteristics of the specific contract[1].

13 The EFRAG Secretariat also notes that it would be important to understand how probability of the insured event is taken into account for these types of contracts and

[1] The February 2020 IASB staff paper referred to "individual basis".

when there is a strong possibility that the cash flows related to the insured risk (such as death) may impact the variability of the cash flows under the contract. For example, new contracts with a death benefit for people over a certain age (depending on the country and gender) may be at risk of not qualifying for VFA. [2] Once such a cut-off point is found, a collection of contracts for people of a younger age do not need to be evaluated unless there are specific circumstances such as pre-existing conditions etc. Therefore, an entity does not need to assess all the contracts individually if these contracts do not have different pricing or underwriting benefits.

14 Once the interaction and 'cut-off' point are understood, some work would be required to update these estimates on an annual basis because the effects need to be determined on a present value basis using current estimates. However, it may be that often only limited cases need to be tested to evidence that the above still holds true. This would be a practical solution compared to how banks implemented the SPPI requirements and EIR measurement under IFRS 9.

15 However, the EFRAG Secretariat notes that where the implementation has been done on a group basis, the amendment would require that such work be reperformed to the extent necessary.

Questions for EFRAG TEG

16 Does EFRAG TEG have further comments on the analysis above?

17 Does this issue warrant inclusion in the EFRAG Draft Endorsement Advice? If so, in what section and what should it cover? Please explain your reasoning.

[2] Even for those contracts where death has a higher likelihood, it is not automatic that these do not represent contracts with substantial investment-related services.