

# **IFRS 17 issues – IFRS 9 interactions**

## *Draft for discussion*

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## 1 Current IASB requirements

### 1.1 IFRS 17 requirements

- 1 IFRS 17.11: An entity shall:
  - (a) apply IFRS 9 to determine whether there is an embedded derivative to be separated and, if there is, how to account for that derivative.
  - (b) separate from a host insurance contract an investment component if, and only if, that investment component is distinct (see paragraphs B31–B32). The entity shall apply IFRS 9 to account for the separated investment component.
- 2 IFRS 17.44: For *insurance contracts without direct participation features*, the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for:
  - (a) the effect of any new contracts added to the group (see paragraph 28);
  - (b) interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates specified in paragraph B72(b);
  - (c) the changes in fulfilment cash flows relating to future service as specified in paragraphs B96–B100, except to the extent that:
    - (i) such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or
    - (ii) such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).
  - (d) the effect of any currency exchange differences on the contractual service margin; and
  - (e) the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph B119.
- 3 IFRS 17.45: For insurance contracts with direct participation features (see paragraphs B101–B118), the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for the amounts specified in subparagraphs (a)–(e) below. An entity is not required to identify these adjustments separately. Instead, a combined amount may be determined for some, or all, of the adjustments. The adjustments are:
  - (a) the effect of any new contracts added to the group (see paragraph 28);

(b) the entity's share of the change in the fair value of the underlying items (see paragraph B104(b)(i)), except to the extent that:

(i) paragraph B115 (on risk mitigation) applies;

(ii) the entity's share of a decrease in the fair value of the underlying items exceeds the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or

(iii) the entity's share of an increase in the fair value of the underlying items reverses the amount in (ii).

(c) the changes in fulfilment cash flows relating to future service, as specified in paragraphs B101–B118, except to the extent that:

(i) paragraph B115 (on risk mitigation) applies;

(ii) such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or

(iii) such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).

(d) the effect of any currency exchange differences arising on the contractual service margin; and

(e) the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period, applying paragraph B119.

4 IFRS 17.B72: An entity shall use the following discount rates in applying IFRS 17:

(a) to measure the fulfilment cash flows—current discount rates applying paragraph 36;

(b) to determine the interest to accrete on the contractual service margin applying paragraph 44(b) for insurance contracts without direct participation features—discount rates determined at the date of initial recognition of a group of contracts, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items;

(c) to measure the changes to the contractual service margin applying paragraph B96(a)–B96(c) for insurance contracts without direct participation features—discount rates applying paragraph 36 determined on initial recognition;

(d) for groups of contracts applying the premium allocation approach that have a significant financing component, to adjust the carrying amount of the liability for remaining coverage applying paragraph 56—discount rates applying paragraph 36 determined on initial recognition;

(e) if an entity chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income (see paragraph 88), to determine the amount of the insurance finance income or expenses included in profit or loss:

- (i) for groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders, applying paragraph B131—discount rates determined at the date of initial recognition of a group of contracts, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items;
- (ii) for groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to policyholders, applying paragraph B132(a)(i)—discount rates that allocate the remaining revised expected finance income or expenses over the remaining duration of the group of contracts at a constant rate; and
- (iii) for groups of contracts applying the premium allocation approach applying paragraphs 59(b) and B133—discount rates determined at the date of the incurred claim, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items.
- 5 IFRS 17.B115: To the extent that an entity meets the conditions in paragraph B116, it may choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity's share of the underlying items (see paragraph B112) or the fulfilment cash flows set out in paragraph B113(b).
- 6 IFRS 17.B116: To apply paragraph B115, an entity must have a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts and, in applying that objective and strategy:
- (a) the entity uses a derivative to mitigate the financial risk arising from the insurance contracts.
- (b) an economic offset exists between the insurance contracts and the derivative, ie the values of the insurance contracts and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity shall not consider accounting measurement differences in assessing the economic offset.
- (c) credit risk does not dominate the economic offset.
- 7 IFRS 17.BC282: IFRS 17 requires the contractual service margin remaining at the end of the reporting period to be allocated equally to the coverage units provided in the period and the expected remaining coverage units. IFRS 17 does not specify whether an entity should consider the time value of money in determining that equal allocation and consequently does not specify whether that equal allocation should reflect the timing of the expected provision of the coverage units. The Board concluded that should be a matter of judgement by an entity.
- 8 IFRS 17.IE17(e): Applying paragraphs 44(e) and B119, the entity recognises in profit or loss in each period an amount of the contractual service margin for the group of insurance contracts to reflect the services provided under the group of insurance contracts in that period. The amount is determined by identifying the coverage units in the

group. These coverage units reflect the quantity of benefits provided under each contract in the group and its expected coverage duration. The entity allocates the contractual service margin at the end of the period (before recognising any amounts in profit or loss) equally to each coverage unit provided in the current period and expected to be provided in the future, and recognises in profit or loss the amount allocated to the coverage units provided in the period. In this example, the service provided in each period for the group of contracts is the same because all contracts are expected to provide the same amount of benefits for all three periods of coverage. Consequently, the amount of the contractual service margin recognised in profit or loss in the period of CU82 is CU247 (CU235 +CU12) divided by three periods of coverage. The entity could achieve the objective of the recognition of the contractual service margin on the basis of the coverage units using a different pattern. For example, the entity could allocate equally in each period the contractual service margin including the total interest expected to be accreted over the coverage period. In this example, the allocation pattern using this method would equal CU86 in each period calculated as  $CU86 = CU235 \times 1.05 \div (1 + 1 \div 1.05 + 1 \div 1.052)$  instead of the increasing pattern of CU82 in Year 1, CU86 in Year 2 and CU91 in Year 3.

9 IFRS 9.4.1.2: A financial asset shall be measured at amortised cost if both of the following conditions are met:

(a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions.

10 IAS 40.32A: An entity may:

(a) choose either the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property; and

(b) choose either the fair value model or the cost model for all other investment property, regardless of the choice made in (a).

11 IAS 40.32B: Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund. Similarly, some entities issue insurance contracts with direct participation features, for which the underlying items include investment property. For the purposes of paragraphs 32A–32B only, insurance contracts include investment contracts with discretionary participation features.. Paragraph 32A does not permit an entity to measure property held by the fund (or property that is an underlying item) partly at cost and partly at fair value. (See IFRS 17 Insurance Contracts for terms used in this paragraph that are defined in that Standard.)

## 1.2 IASB decisions

- 12 IASB 2018-12 AP 2B.6: IFRS 17 requires an entity to adjust (ie unlock) the contractual service margin for changes in estimates of cash flows that relate to future service. When measuring the fulfilment cash flows, these changes in estimates are measured consistently with all other aspects of the fulfilment cash flows using a current discount rate. For insurance contracts without direct participation features the adjustment to the contractual service margin is determined using the discount rate that applies on initial recognition (ie the locked-in discount rate).
- 13 IASB 2018-12 AP 2B.7: This leads to a difference between the change in the fulfilment cash flows and the adjustment to the contractual service margin—the difference between the change in the cash flows measured at a current rate and the change in the cash flows measured at the locked-in discount rate. That difference:
- (a) represents the cumulative effect of changes in financial variables on the underlying change in estimates between the date the insurance contracts were initially recognised and the date of the change in estimates; and
  - (b) gives rise to a gain or loss that is included in profit or loss or other comprehensive income (OCI), depending on the accounting policy choice an entity makes for the presentation of insurance finance income or expenses in the statement(s) of financial performance.
- 14 IASB 2019-03 AP 2D.36: The staff think that excluding from the scope of IFRS 17 credit card contracts that provide insurance coverage for which the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer would:
- (a) permit the continuation of the existing accounting practice discussed in paragraph 20(b) of this paper and therefore reduce IFRS 17 implementation costs for some entities. Amending IFRS 17 by permitting the continuation of the existing accounting practice would not require the Board to consider to amend the disclosure and transition requirements in IFRS Standards for such credit card contracts.
  - (b) not result in a significant loss of useful information relative to that which would be provided by IFRS 17 for users of financial statements. Other relevant IFRS Standards would apply to such credit card contracts and would provide relevant information about the components of those contracts to users of financial statements. Entities would continue to apply the existing accounting practice discussed in paragraph 20(b) of this paper.
- 15 IASB 2019-03 AP 2D.38: Accordingly, the staff think that an entity issuing a credit card contract that provides insurance coverage and that would be excluded from the scope of IFRS 17 would, for example, be in the scope of:
- (a) IFRS 9 for the loan or loan commitment (including the insurance elements) and any interest revenue charged if the customer does not settle the credit card balance in full by a specified date;<sup>7</sup>

(b) IFRS 15 for revenue from contracts with customers for other services provided by the entity, such as access to airport lounges; and

(c) IAS 37 if the contract in the scope of IFRS 15 is, or has become, onerous and in circumstances not covered by another IFRS Standard.

- 16 IASB 2019-03 AP 2D.40: In addition to the example of the credit card contract discussed in paragraph 13 of this paper, which provide insurance coverage for a supplier failure, the staff acknowledge that the possible scope exclusion discussed in paragraph 36 of this paper might capture other types of credit card contracts that provide insurance coverage for which the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer, such as travel insurance provided for a fixed fee. The staff note that the considerations in paragraph 35–38 of this paper would also be relevant to those other types of credit card contracts.
- 17 IASB 2019-02 AP 2A.43: Accordingly, the staff recommend the Board amend the scope of IFRS 17 and IFRS 9 for insurance contracts for which the only insurance in the contract is for the settlement of some or all of the obligation created by the contract, by adding a scope exclusion in IFRS 17 so that an entity may apply either IFRS 17 or IAS 32, IFRS 7 and IFRS 9 to such contracts that it issues.
- 18 IASB 2019-02 AP 2A.44: Such amendment to the scope of IFRS 9 would require consequential amendments to IFRS 7 and IAS 32. The staff note that if the Board were to amend IFRS 17 to permit an entity to apply IFRS 9 to those contracts the staff will consider possible implications to the transition and disclosures requirements at a future Board meeting.

### *1.3 Current understanding of the accounting treatment*

#### Scope – IFRS 9 components in insurance contracts

- 19 IFRS 17 does not allow for separating IFRS 9 components from an insurance contract except for derivatives and distinct investment components (meeting specific criteria).
- 20 Addressing certain issues, the Board has decided to create scope exceptions in IFRS17:
- allowing to apply another standard to insurance contracts embedded in loans (covering the settlement of the remaining policyholder’s obligation) (AP2A 2019-02, AP2F 2019-03);
  - requiring to apply another standard to insurance contracts embedded in credit cards (as long as not specifically priced for the customer) (AP2D 2019-03).

#### Measurement inconsistencies – Risk mitigation

- 21 The risk mitigation option (IFRS 17.B115 to B118) allows not adjusting the CSM for the changes in value of derivatives hedging financial risks, provided that it complies with documented risk-management objectives and strategies. This option allows for a consistent treatment between the changes in the hedged cash flows of VFA contracts

and the related hedging instruments (both in P&L). This option is not available to non-VFA contracts.

#### Measurement inconsistencies – Discount rate

- 22 IFRS 17 requires the CSM to be adjusted for changes in estimates of future cash flows that relate to future service. For insurance contracts without direct participation features, the adjustments to the CSM are made using the discount rate estimated at initial recognition (the “locked-in” discount rate). In contrast, the changes in estimates are measured using the current discount rate when measuring the fulfilment cash flows.
- 23 The difference between the locked-in and the current rate gives rise to a gain or loss that is reflected in the profit or loss (i.e. insurance finance income or expenses) or in other comprehensive income (OCI), depending on the accounting policy option an entity makes for the presentation of the insurance finance result.

## **2 Issue**

- 24 Relations between IFRS 9 and IFRS 17 have been analysed twofold:
- Regarding the scope of the standard;
  - Regarding possible measurement inconsistencies between assets and liabilities that are supposed to be economically consistent (thanks to asset/liability management, ALM or risk mitigation).
- 25 By definition, participating insurance contracts are closely linked with assets the return of which is allocated to policyholders. Therefore, their measurement crystallises specific ALM issues. VFA generally provides solutions that efficiently mitigate financial risks (such as a change in discount rate) whereas the general model does not, even if, economically, it is supposed to pass through the financial risk to policyholders so that the entity has limited exposure to such financial risks.

### *2.1 Scope – IFRS 9 components in insurance contracts*

- 26 Insurance contracts may include a significant financial component or financial instruments may include insurance services. For instance, loans or credit card sometimes include insurance services in the scope of IFRS 17. IFRS 17 current requirements do not allow such insurance services to be separately recognised so that the whole financial contract would have to be accounted for according to IFRS 17 instead of previously applied IAS 39/IFRS 9. However, the board has decided to create specific exemptions (optional or mandatory) that properly address and solve these issues.

### *2.2 Measurement inconsistencies – Equity investment*

#### Non-recycling of OCI on equity investment is a significant insurance issue

- 27 According to IFRS 9.5.7.5 an entity may elect (on an instrument-by-instrument basis) to present changes in fair value of equity instruments in OCI instead of in the P&L. However, those amounts are not recycled into P&L on disposal.
- 28 This issue is not a specific IFRS 17 issue but due to the “reverse cycle” model of insurance business where cash is gathered before the entity performs (different from usual other businesses), investment is a very substantial component of the



performance of the insurance activity. Never recognising the performance accumulated in OCI thus becomes a major issue.

- 29 Because they are in a “long cash position” and since their activity is stable on the long run, insurers are key long-term investors. Measuring their whole portfolio at fair value through P&L would present a volatility that would not reflect the long-term performance and stability of their ALM management. This would especially affect investments in equity instruments which is part of their business model as they permit to provide higher yields than investment in bonds and therefore to propose more attractive tariffs to policyholders.

#### The equity instruments issue is addressed but limited to VFA contracts

- 30 IFRS 17 partially addresses this specific concern thanks to the Variable Fee Approach. VFA contracts indeed allow for adjusting the CSM by changes in fair value of the underlying assets. By doing so, the VFA eliminates the equity investment issue and proves adequate *as long as assets are recorded at FVPL* under IFRS 9. However, if assets are recorded at FVOCI under IFRS 9, VFA only eliminates the mismatches if the OCI option is applied.
- 31 This conclusion applies to the cash flows directly related to VFA insurance contracts and their underlying items. However, insurance companies are also required to hold equity and reserves attributable but not immediately distributable to shareholders. Such “restricted equity” is necessary for regulatory/solvency purposes for running their insurance activities. For economic reasons (the shareholders expecting higher returns because of such longstanding restrictions) equity-investments (supposed to provide higher returns than debt-instruments) may represent a large part of the assets invested with such restricted shareholders’ equity.
- 32 Finally, for all approaches except VFA (general model, PAA, reinsurance, investment on its own) the non-recycling of OCI on IFRS 9 equity investments remains an issue.

#### *2.3 Measurement inconsistencies – IFRS 17 implies applying a fair value measurement to assets*

- 33 Applying the VFA to an insurance contract, liabilities are reflected at their current value regardless of the measurement retained on the asset side. In order for changes in fair value of assets to be properly matched (in P&L or OCI), a measurement of assets at current value is promoted. Applying historical costs instead would automatically generate a mismatch either in the P&L or in the OCI. Accordingly, applying the VFA, creates a disincentive to choosing another measurement of assets than fair value, regardless of the business model that would best fit applying IFRS 9 solely.
- 34 The effects of this preference may not be limited to VFA contracts. If an asset covers several types of insurance contracts (some being VFA others not), applying historical cost measurement to assets will create a mismatch in the VFA part, whereas applying fair value may create undesired volatility in the non-VFA part. This situation may happen to financial assets in a general fund or even to non-financial assets such as investment property (applying IAS 40).
- 35 This issue has been exacerbated by:
- The limitation to the application of the FVOCI applying IFRS 9 business models. For instance, investing in a SPPI Held-to-collect debt instrument, an entity will be enticed to apply fair value (because of IFRS 17) but prevented from applying FVOCI (because of the IFRS 9 business model) which eventually may lead to apply the FVPL.

- The prohibition to disaggregate investment property (IFRS 17 amendment of IAS 40)

#### 2.4 Measurement inconsistencies – Risk mitigation

- 36 Hedging a financial asset (and more generally an underlying item) is addressed by IFRS 9 provisions. For instance, an interest rate swap on a financial asset is integral part of the underlying assets and thus is not dealt with in IFRS 17.
- 37 By contrast, risk mitigation in IFRS 17.B115-B118 addresses hedged items that are not the underlying assets. IFRS 17 provides an optional alternative measurement to hedged items that would otherwise have impacted the entity's margin, the CSM. In order to match the changes in the derivatives, these provisions allow for recording in the P&L instead of in the CSM the corresponding financial risk's component of changes in the value of underlying items.
- 38 IFRS 17 only deals with derivatives that hedge financial risk in VFA contracts. Conversely, risk mitigation provisions do not prevent certain non-financial risks (e.g. weather derivatives) hedging strategies from generating accounting mismatches with the CSM.
- 39 Risk mitigation provisions under IFRS 17 only provide alternative accounting treatment of the CSM by permitting to transfer from the CSM to P&L financial-related amounts previously accounted for in the CSM so as to match in P&L similar impacts on related derivatives. If an entity applies the OCI option (IFRS 17.88-89) the financial risk would be reflected in OCI instead of CSM, whereas the hedging instrument (derivative) would be recorded at FVPL. As IFRS 17 does not provide currently for a transfer from OCI to P&L to reflect risk mitigation, accounting mismatches would appear whereas, economically, the risk is mitigated. Not using the OCI option may not solve the mismatch issue as it creates other accounting mismatches to the extent other underlying financial assets are not at FVPL.
- 40 IFRS 17 allows a risk mitigation treatment for products accounted for under the VFA model where derivatives are used to hedge options and guarantees. There is no rationale not to extend this treatment to other non VFA contracts that have similar guarantees.

#### 2.5 Measurement inconsistencies – Discount rate

- 41 The impact of a change in discount rate depends on:
- whether VFA is applied or not;
  - whether OCI-option is applied or not;
  - the measurement model applied to assets under IFRS 9 (amortised cost, FVOCI or FVPL).
- 42 All these effects are illustrated in the example 1 in Chapter 4. The conclusions are as follows:
- 43 When the VFA is applied, the OCI option (IFRS 17.89(b)) is not necessary if assets are measured at FVPL.
- 44 VFA and OCI option are also efficient in neutralising the P&L effect of changes in discount rate when assets are measured at FVOCI or amortised cost. Amortised cost however then creates volatility in the OCI.
- 45 Under the general model (with or without the OCI option in IFRS 17.88(b)) changes in the IFRS 17 discount rate after initial recognition do not lead to remeasure the CSM.

The discount rate is “locked-in”. The fact that the CSM is not remeasured for changes in the IFRS 17 discount rate is equivalent to having a portion of the insurance liability not measured on a current basis, giving rise to amounts in P&L/OCI that do not completely reflect the fair value remeasurement of the corresponding financial assets.

- 46 Changes in discount rate affecting the assets may actually be matched (in OCI or P&L) by corresponding changes in discount rate on LRC, but not in the shareholder’s part since the CSM is not remeasured. As a result, even when cash-flows and therefore the insurer’s margin are economically locked-in from inception:
- Applying the OCI option, the volatility in OCI temporarily increases even if changes in OCI relating to the CSM will reverse;
  - Not applying the OCI option (i.e. changes are reflected in the P&L), entities may still be concerned by the complexity to follow in their accounting IT systems a locked-in discount rate in addition to the current rate for the purpose of CSM calculation.

*Illustrative example of the effect of changes in discount rate*

- 47 Example 1 (in § 75) presents the contrasting situations where:
- According to the VFA, the CSM at the end of Y (before allocation) amounts to  $517=421*1,05^5/1,01^4$  (discounting @1% current rate at year-end); and
  - According to the general model, the CSM at the end of Y (before allocation) amounts to  $442=421*1,05^5/1,05^4$  (discounting @5% locked-in rate).
- 48 The difference amounts to  $517-442=75$ . As illustrated in the overview (in § 89), the change in discount rate creates volatility in OCI (see Sc. Bo2 in § 99) or in the P&L (see Sc. Bn3 in § 102). As long as the liability for remaining coverage (LRC) is supposed to decrease down to nil, the effect in OCI (all things being equal) is expected to reverse. Accordingly the created volatility (in the P&L or OCI) is temporary until the insurance contract expires.

### **3 Suggested solution (tentative)**

#### *3.1 Scope – IFRS 9 components in insurance contracts*

- 49 ANC suggests no further improvement to the suggested amendments decided at the IASB meeting in February 2019.

#### *3.2 Measurement inconsistencies – Equity investment*

- 50 Non-recycling OCI on equity investment and the accounting treatment of funds (UCITS, AIF) is an issue for all insurance contracts but those accounted for under the VFA. This remains also an issue for an entity investing on its own (see § 31). It is finally a broader issue than IFRS 17 and may better be addressed at IFRS 9 level.

#### *3.3 Measurement inconsistencies – IFRS 17 implies fair value measurement to assets*

- 51 Since insurance contracts are measured at current value, any corresponding asset is best matched when also measured at current value, i.e. fair value. This core principle in IFRS 17 leads to application issues (for instance by segregating assets into ringfenced pools or accepting the created mismatch) that can hardly be solved by standard-setting.

- 52 However, targeted improvements are possible in facilitating the alignment of the measurement of underlying assets with the measurement of the insurance contract (at current value, possibly with OCI option):
- by allowing measuring loans at FVOCI even if the IFRS 9 business model is held-to-collect i.e. adding a FVOCI option similar to the existing FVPL in IFRS 9.4.1.5;
  - by splitting investment property providing returns to different types of contracts (amending IAS 40.32A and IAS 40.32B)

Suggested amendments:

- 53 IFRS 9.4.1.6 Despite paragraph 4.1.2, an entity may, at initial recognition, irrevocably designate a financial asset that would otherwise be measured at amortised cost as measured at fair value through other comprehensive income (with subsequent transfer to profit or loss) if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’) that would otherwise arise from measuring the related liabilities through other comprehensive income.
- 54 IAS 40.32A: An entity may:
- (a) choose either the fair value model or the cost model for **all each** investment property (or a part of it) backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property (or a part of it); and
  - (b) choose either the fair value model or the cost model for all other investment property, regardless of the choice made in (a).
- 55 IAS 40.32B: Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund. Similarly, some entities issue insurance contracts with direct participation features, for which the underlying items include investment property. For the purposes of paragraphs 32A–32B only, insurance contracts include investment contracts with discretionary participation features. ~~Paragraph 32A does not permit an entity to measure property held by the fund (or property that is an underlying item) partly at cost and partly at fair value.~~ (See IFRS 17 Insurance Contracts for terms used in this paragraph that are defined in that Standard.)

*3.4 Measurement inconsistencies – Risk mitigation*

- 56 Risk mitigation provisions relate to the CSM mechanism (rather than to VFA) and therefore should also be available in the general model (amending IFRS 17.44).
- 57 Risk mitigation provisions should also address non-financial risks (e.g. weather derivatives) (amending IFRS 17.B115-B118).
- 58 Risk mitigation provisions should finally address changes recorded in OCI, when applying the OCI option (IFRS 17.88-89) (amending IFRS 17.B115-B118).

Suggested amendments:

- 59 IFRS 17.44: For insurance contracts without direct participation features, the carrying amount of the contractual service margin of a group of

contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for:

(a) the effect of any new contracts added to the group (see paragraph 28);

(b) interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates specified in paragraph B72(b);

(c) the changes in fulfilment cash flows relating to future service as specified in paragraphs B96–B100, except to the extent that:

(i) such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or

(ii) such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).

(iii) paragraph B115 (on risk mitigation) applies;

(d) the effect of any currency exchange differences on the contractual service margin; and

(e) the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph B119.

60 IFRS 17.B115: To the extent that an entity meets the conditions in paragraph B116, it may choose not to recognise a change in the contractual service margin or in other comprehensive income (applying paragraph 88(b) or 89(b)) to reflect some or all of the changes in the effect of ~~financial~~ the mitigated risk on the entity's share of the underlying items (see paragraph B112) or the fulfilment cash flows ~~set out in paragraph B113(b)~~.

### 3.5 Measurement inconsistencies – Discount rate

61 “Locked-in” rate creates temporary OCI-volatility in participating contracts not meeting the VFA criteria. This concern could be solved by reconsidering and extending VFA criteria (amending IFRS 17.B101).

#### 4 Appendix 1: Illustrative examples on participating contracts

##### Basis assumptions

- 62 Considering the case where a commitment against a policyholder is economically matched by an appropriate investment of the premium, different scenarios offered by IFRS 9 and IFRS 17 are illustrated to track possible measurement inconsistencies (accounting mismatches).
- 63 An insurance company issues 10 contracts with an individual premium of 1 000. The contracts share the returns of assets segregated in a dedicated fund and are entitled to a minimum of 80% of the returns from the pool. The contract duration is five year. For commercial reasons, management credits all policyholders' accounts using a single crediting rate. The contracts are investment contracts with discretionary participation features that fall under IFRS 17. From an economic standpoint, the entity has locked-in its margin /financial risk/ cash-flows.
- 64 The premiums are assumed to be paid on January 1<sup>st</sup> and immediately invested in bonds with a 5 year maturity and an interest rate of 5 % capitalised until maturity. The credit risk of the bonds is assumed to be negligible. Coupons are not invested and remain on the insurer's bank account.
- 65 For simplicity reason, it is assumed that the company starts its activity in Y and has no other portfolios. Furthermore, the CSM is allocated to profit and loss based on the passage of time and no risk adjustment for non-financial risk is considered. In future periods, everything happens as expected at inception.
- 66 The dedicated portfolio of assets is considered as the reference portfolio for the determination of the discount rate. The bonds bear no credit risk and the entity decides to apply the option in IFRS 17.B81 not to adjust the reference portfolio's rate for differences in the liquidity characteristics. Therefore, the discount rate equals the rate of return implicit in the fair value of the dedicated portfolio of assets.

##### Additional assumptions and resulting scenarios

- 67 Applying IFRS 9, the bonds may be accounted for at (Sc.1) amortised cost, (Sc.2) FVOCI or (Sc.3) FVPL.
- 68 The example will assume that the contracts (A) meet the criteria for the variable fee approach (IFRS 17.B101) or (B) do not meet those criteria. Moreover, it will be distinguished in both cases whether the entity applies the OCI option (IFRS 17.89(b) for VFA-contracts and IFRS 17.88(b) for the others) or not.
- 69 Accordingly, 12 following scenarios are considered in the example:

	VFA		Non-VFA	
	w. OCI option	w/o OCI	w. OCI option	w/o OCI
Amortised cost	Ao1	An1	Bo1	Bn1
FVOCI	Ao2	An2	Bo2	Bn2
FVPL	n.a.	An3	n.a.	Bn3

##### Initial recognition and interest earned during the period

- 70 The investment in bonds will provide a cash inflow of  $10\,000 \times 1.05^5 = 12\,763$  in year 5 (Y+4).
- 71 The insurance company expects to make a final pay-out upon year Y+4 with an implicit yearly yield rate of 4,1% for the policyholder. The final expected payment is

therefore  $10\,000 \times 1.041^5 = 12\,225$ . The participation of the policyholders is therefore  $2\,225 / 2\,763 = 80\%$  and the insurer's fee amount to 538 ( $2\,763 - 2\,225$ ).

72 At initial recognition the discounted value of the payment is  $12\,225 / 1.05^5 = 9\,579$ .

73 The initial CSM is therefore  $10\,000 - 9\,579 = 421$

	Debit	Credit
Cash	10 000	
Provision for remaining coverage		9 579
Contractual service margin		421
To record the initial recognition of the insurance contracts		

74 The entity records the interests earned over the period :  $5\% \times 10\,000$

	Debit	Credit
Bonds	500	
Finance income		500
To record the returns on bonds at the end of year Y		

At the end of year Y: change in discount rate

75 At the end of year Y, the market interest rate for bonds goes down to 1%. For simplicity reason, yield curves are assumed to be flat. The rates are constant afterwards.

#### **Application of IFRS 9 to the investments**

76 As interest rate have fallen to 1%, the fair value of the bonds has increased up to  $10\,000 \times 1.05^5 / 1.01^4 = 12\,265$ .

77 The change in the fair value of the underlying assets amounts to  $12\,265 - 10\,000 = 2\,265$ . This change may or may not be accounted for depending on the measurement applied under IFRS 9:

78 Applying amortised cost: no change is recorded;

79 Applying FVOCI, the change in fair value is reflected in OCI  $2\,265 - 500 = 1\,765$ ;

	Debit	Credit
Financial assets	1 765	
OCI		1 765
To record the change in FV, if financial assets are recorded at FVOCI.		

80 Applying FVPL, the change in fair value is reflected in financial income;

	Debit	Credit
Financial assets	1 765	
Financial income		1 765
To record the change in FV, if financial assets are recorded at FVPL.		

#### **Change in the liability for remaining coverage**

81 The discount rate for the determination of the liability for remaining coverage is updated to reflect the current market rate of returns implicit in the fair value

measurement of the reference portfolio, which is 1 %. The liability for remaining coverage under IFRS 17 is the discounted value of the expected terminal payment which is  $10\,000 \times 1.041^5 / 1.01^4 = 11\,748$ . The increase is  $11\,748 - 9\,579 = 2\,169$ .

82 The changes in the liability for remaining coverage can be broken down as follows:

<b>Opening balance</b>	<b>9 579</b>
Unwind of the discount rate = $9\,579 \times 5\%$	479
Impact of the change in discount rate = $12\,225 / 1.01^4 - 12\,225 / 1.05^4$	1 690
<b>Closing balance</b>	<b>11 748</b>

	Debit	Credit
Insurance finance expense	2 169	
Liability for remaining coverage		2 169
To record the effect of the time value of money and the change in interest rate applying IFRS 17. 88 (a)		

### Application of IFRS 17 to contracts meeting the VFA criteria

83 As the contracts are accounted for under the variable fee approach, the entity updates the CSM by 96, the difference between :

- the change in the fair value of the underlying assets :  $12\,265 - 10\,000 = 2\,265$
- the change in the liability for remaining coverage :  $9\,579 - 11\,748 = -2\,169$

	Debit	Credit
Insurance finance expense	96	
Contractual service margin		96
To adjust the CSM for the entity's share in the fair value of the underlying items.		

84 In addition, as the entity holds the underlying items, it may choose (Ao1 or Ao2) to disaggregate the insurance finance income between profit and loss and OCI (applying IFRS 17.89(b)). The difference is  $2\,169 + 96 - 500 = 1\,690 + 75 = 1\,765$ . The entry would be as follows:

	Debit	Credit
Other comprehensive income	1 765	
Insurance finance expense		1 765
To disaggregate finance income according to IFRS 17.B134		

85 Finally, the entity records the release of the contractual service margin to profit and loss =  $(421 + 96) \times 1 / 5 = 103$ .

	Debit	Credit
Contractual service margin	103	
Insurance revenue		103
To record the allocation of CSM during the period		

### Application of IFRS 17 to contracts *not* meeting the VFA criteria

86 The example assumes that no change in future discretionary cash flows is expected (i.e. the only change results from a change in discount rate). The CSM thus remains



unchanged. If the entity chooses to disaggregate the insurance finance income between profit and loss and OCI applying IFRS 17.88(b) [OCI option], the systematic allocation is based on the initial rate of 5%.

	Debit	Credit
Insurance finance expense		1 690
Other comprehensive income	1 690	
To disaggregate finance income according to IFRS 17.B132		

- 87 Furthermore, applying IFRS 17.B72(b) the entity records the accretion of the contractual service margin at the locked-in rate of 5% = 421 x5% = 21

	Debit	Credit
Insurance finance expense	21	
Contractual service margin		21
To record the accretion in CSM		

- 88 Finally, the entity records the release of the contractual service margin to profit and loss = (421 +21) x1 /5 =88.

	Debit	Credit
Contractual service margin	88	
Insurance revenue		88
To record the allocation of CSM during the period		

### Conclusion on mismatches for the 12 scenarios considered

- 89 The conclusion on the 12 scenarios considered is as follows:

	VFA		Non-VFA	
	w. OCI option	w/o OCI	w. OCI option	w/o OCI
Amortised cost	OCI: -1,765 P&L: 0	OCI: 0 P&L: -1,765	OCI:-1,690 P&L:0	OCI:0 P&L:-1,690
FVOCI	OCI: 0 P&L: 0	OCI: 1,765 P&L: -1,765	OCI:75 P&L:0	OCI:1,765 P&L:-1,690
FVPL	n.a.	OCI: 0 P&L: 0	n.a.	OCI: 0 P&L: 75

- 90 VFA contracts allow for adjusting the CSM by changes in fair value of the underlying assets. By doing so, the VFA eliminates the equity investment issue and proves adequate *as long as assets are recorded at FVPL* under IFRS 9. However, if assets are recorded at FVOCI under IFRS 9, VFA only eliminates the mismatches if the OCI option is applied.
- 91 Finally, for all approaches except VFA (general model, PAA, reinsurance), applying IFRS 9 FVOCI to equity investments creates amounts in OCI that are not mitigated by the measurements of the corresponding liabilities under IFRS 17.

### Booking entries

92 12 following scenarios are considered in the example:

	VFA		Non-VFA	
	w. OCI option	w/o OCI	w. OCI option	w/o OCI
Amortised cost	Ao1	An1	Bo1	Bn1
FVOCI	Ao2	An2	Bo2	Bn2
FVPL	n.a.	An3	n.a.	Bn3

93 Sc.Ao1: VFA +OCI option +assets at amortised cost [Before CSM allocation]:

B/S as of 31/12/Y			
Bond	$10,000+500=10,500$	Ret.E	
		OCI	$-1,690-75=-1,765$
		P&L	0
		LRC	$9,579+479+1,690=11,748$
		CSM	$421+96=517$
	<u>10,500</u>		<u>10,500</u>
P&L Y			
Insurance finance expense	$479+96-75=500$	Financial income	500
	<u>500</u>		<u>500</u>

94 Sc.Ao2: VFA +OCI option +assets at FVOCI [Before CSM allocation]:

B/S as of 31/12/Y			
Bond	$10,000+500+1,765=12,265$	Ret.E	
		OCI	$1,765-1,690-75=0$
		P&L	0
		LRC	$9,579+479+1,690=11,748$
		CSM	$421+96=517$
	<u>12,265</u>		<u>12,265</u>
P&L Y			
Insurance finance expense	$479+96-75=500$	Financial income	500
	<u>500</u>		<u>500</u>

95 Sc.An1: VFA +assets at amortised cost [Before CSM allocation]:

B/S as of 31/12/Y			
Bond	$10,000+500=10,500$	Ret.E	
		OCI	0
		P&L	-1,765
		LRC	$9,579+479+1,690=11,748$
		CSM	$421+96=517$
	<u>10,500</u>		<u>10,500</u>

P&L Y			
Insurance finance expense	$1,690+479+96=2,265$	Financial income	500
	<u>2,265</u>	Loss	<u>1,765</u>
			<u>2,265</u>

96 Sc.An2: VFA +assets at FVOCI [Before CSM allocation]:

B/S as of 31/12/Y			
Bond	$10,000+500+1,765=12,265$	Ret.E	
		OCI	1,765
		P&L	-1,765
		LRC	$9,579+479+1,690=11,748$
		CSM	$421+96=517$
	<u>12,265</u>		<u>12,265</u>

P&L Y			
Insurance finance expense	$1,690+479+96=2,265$	Financial income	500
	<u>2,265</u>	Loss	<u>1,765</u>
			<u>2,265</u>

97 Sc.An3: VFA +assets at FVPL [Before CSM allocation]:

B/S as of 31/12/Y			
Bond	$10,000+500+1,765=12,265$	Ret.E	
		OCI	
		P&L	0
		LRC	$9,579+2,169=11,748$
		CSM	$421+96=517$
	<u>12,265</u>		<u>12,265</u>

P&L Y			
Insurance finance expense	$2,169+96$	Financial income	$500+1,765=2,265$
	<u>2,265</u>		<u>2,265</u>

- 98 Sc.Bo1: General Model + OCI option+ assets at amortised cost [Before CSM allocation]

B/S as of 31/12/Y			
Bond	10,000+500=10,500	Ret.E	
		OCI	-1,690
		P&L	0
		LRC	9,579+479+1,690=11,748
		CSM	421+21=442
	<u>10,500</u>		<u>10,500</u>

P&L Y			
Insurance finance expense	479+21	Financial income	500
	<u>500</u>		<u>500</u>

- 99 Sc.Bo2: General Model + OCI option+ assets at FVOCI [Before CSM allocation]

B/S as of 31/12/Y			
Bond	10,000+500+1,765=12,265	Ret.E	
		OCI	1,765-1,690=75
		P&L	0
		LRC	9,579+479+1,690=11,748
		CSM	421+21=442
	<u>12,265</u>		<u>12,265</u>

P&L Y			
Insurance finance expense	479+21	Financial income	500
	<u>500</u>		<u>500</u>

- 100 Sc.Bn1: General Model + assets at amortised cost [Before CSM allocation]

B/S as of 31/12/Y			
Bond	10,000+500=10,500	Ret.E	
		OCI	
		P&L	-1,690
		LRC	9,579+479+1,690=11,748
		CSM	421+21=442
	<u>10,500</u>		<u>10,500</u>

P&L Y			
Insurance finance expense	1,690+479+21=2,190	Financial income	500
	<u>2,190</u>	Loss	<u>1,690</u>
			<u>2,190</u>

101 Sc.Bn2: General Model + assets at FVOCI [Before CSM allocation]

B/S as of 31/12/Y			
Bond	$10,000+500+1,765=10,500$	Ret.E	
		OCI	1,765
		P&L	-1,690
		LRC	$9,579+479+1,690=11,748$
		CSM	$421+21=442$
	<u>12,265</u>		<u>12,265</u>

P&L Y			
Insurance finance expense	$1,690+479+21=2,190$	Financial income	500
	<u>2,190</u>	Loss	<u>1,690</u>
			<u>2,190</u>

102 Sc.Bn3: General Model + assets at FVPL [Before CSM allocation]

B/S as of 31/12/Y			
Bond	$10,000+500+1,765=12,265$	Ret.E	
		OCI	0
		P&L	75
		LRC	$9,579+479+1,690=11,748$
		CSM	$421+21=442$
	<u>12,265</u>		<u>12,265</u>

P&L Y			
Insurance finance expense	$1,690+479+21=2,190$	Financial income	$500+1,765=2,265$
Gain	<u>75</u>		
	<u>2,265</u>		<u>2,265</u>