

# 2nd Capacity Building Seminar on IFRS 17 Hotel Sea Princess 14 February 2019

Methodology deep-dive:  
measurement approach for  
participating products



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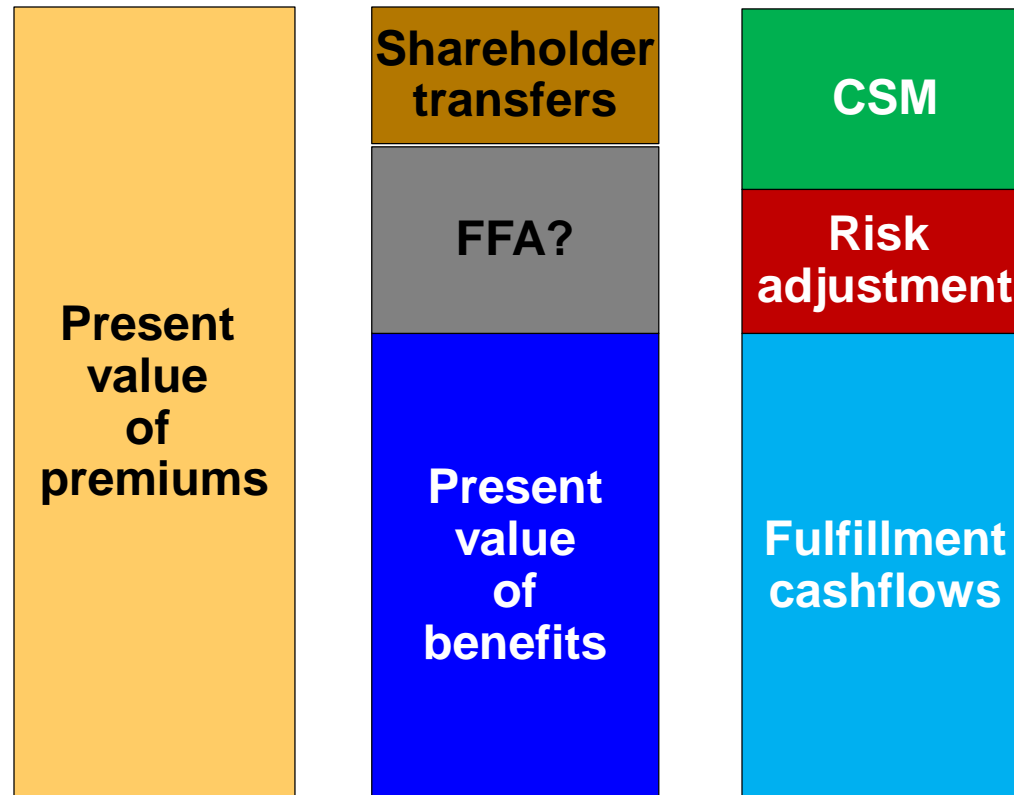
# Introduction



Two key questions:

- Whether GMM or VFA applies – or both?
- Whether the financial statements envisaged under IFRS 17 are fit for use in par business, taking into account current laws and regulations.

# How does measurement stack up?



**How do we investigate  
whether par contracts have  
DPF?**

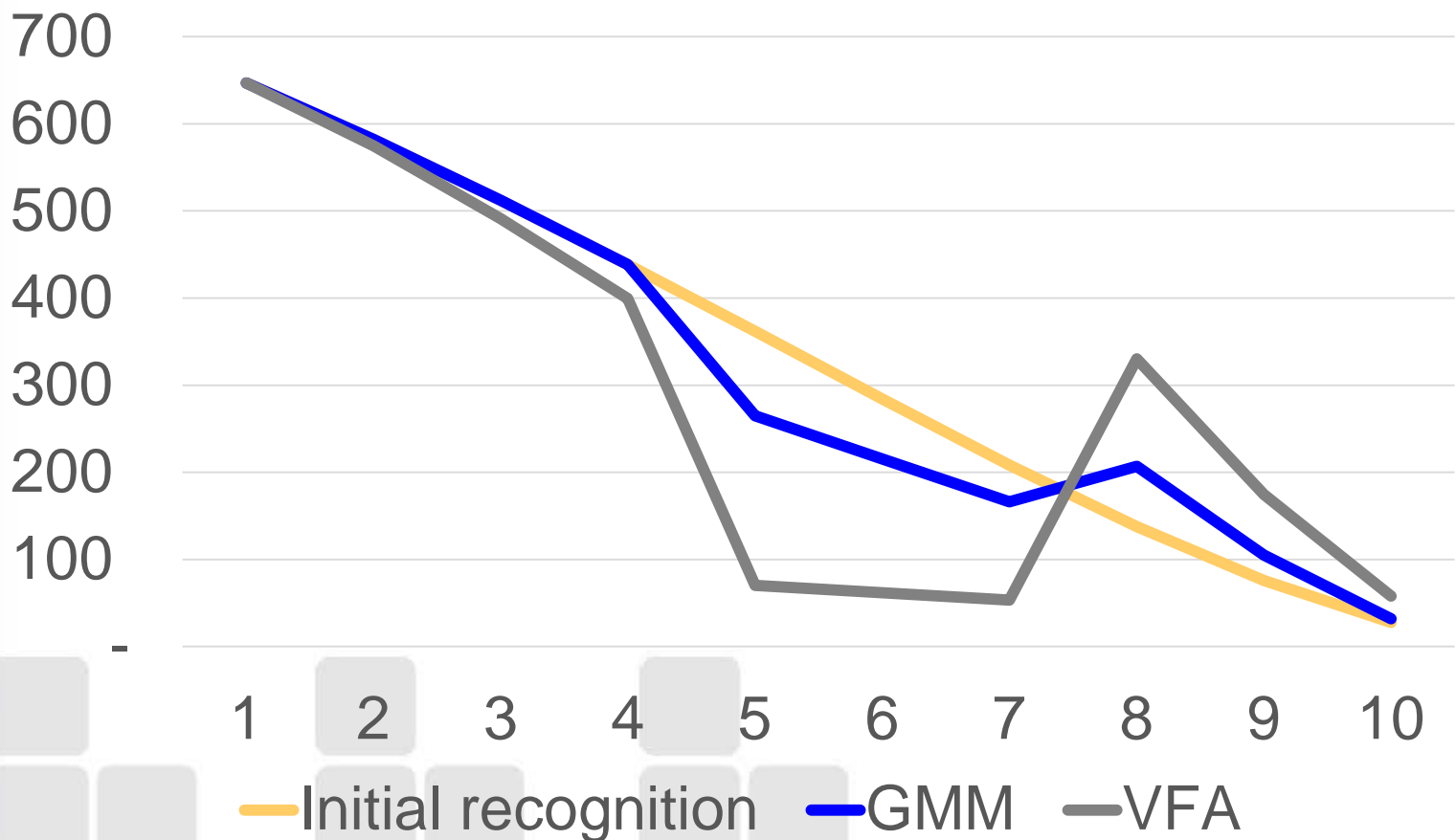


# Impact of the model choice

An example contract under both measurement models



## Contractual service margin

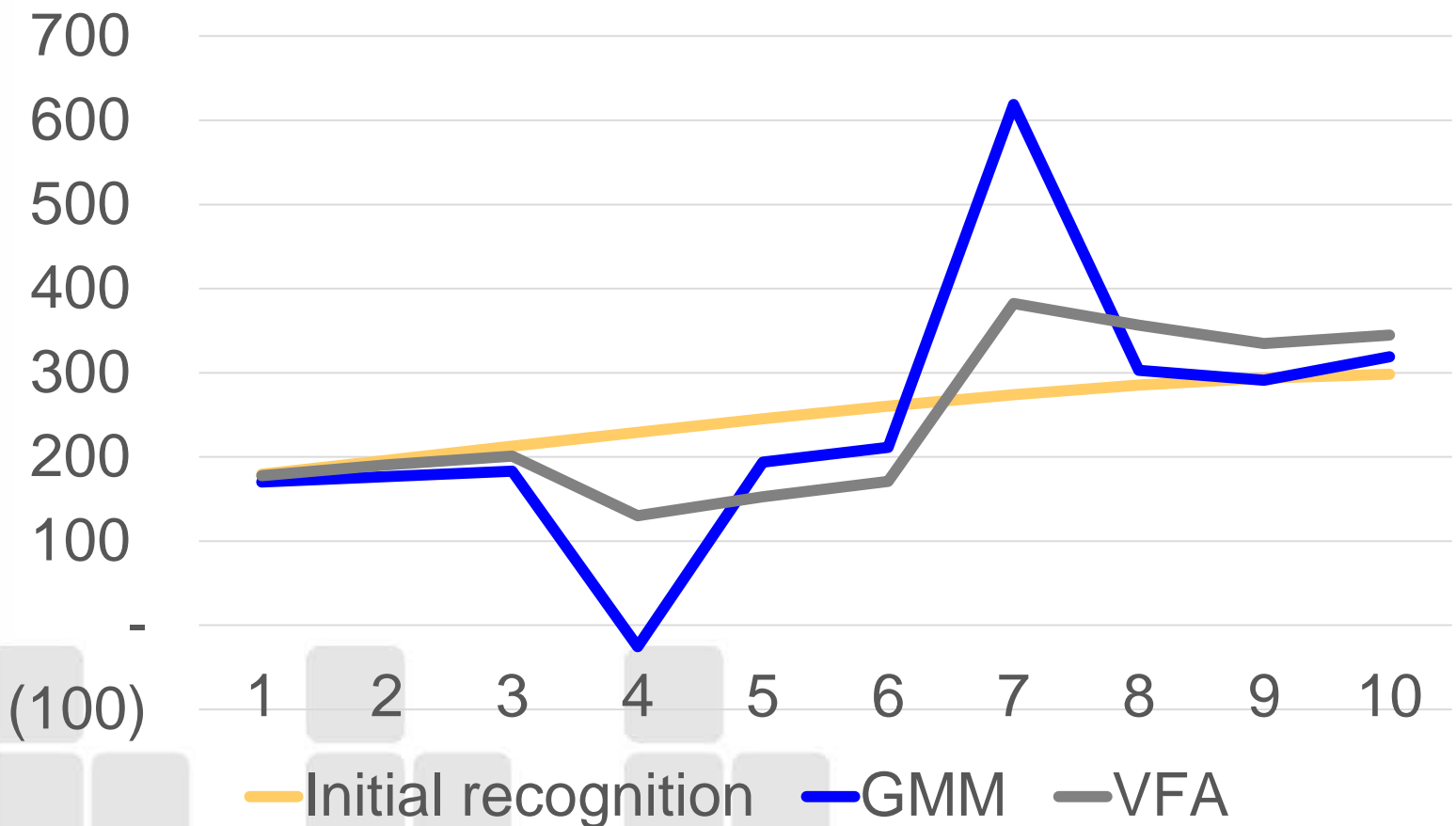


# Impact of the model choice

An example contract under both measurement models



## Total comprehensive income



# Comparison to existing P&L

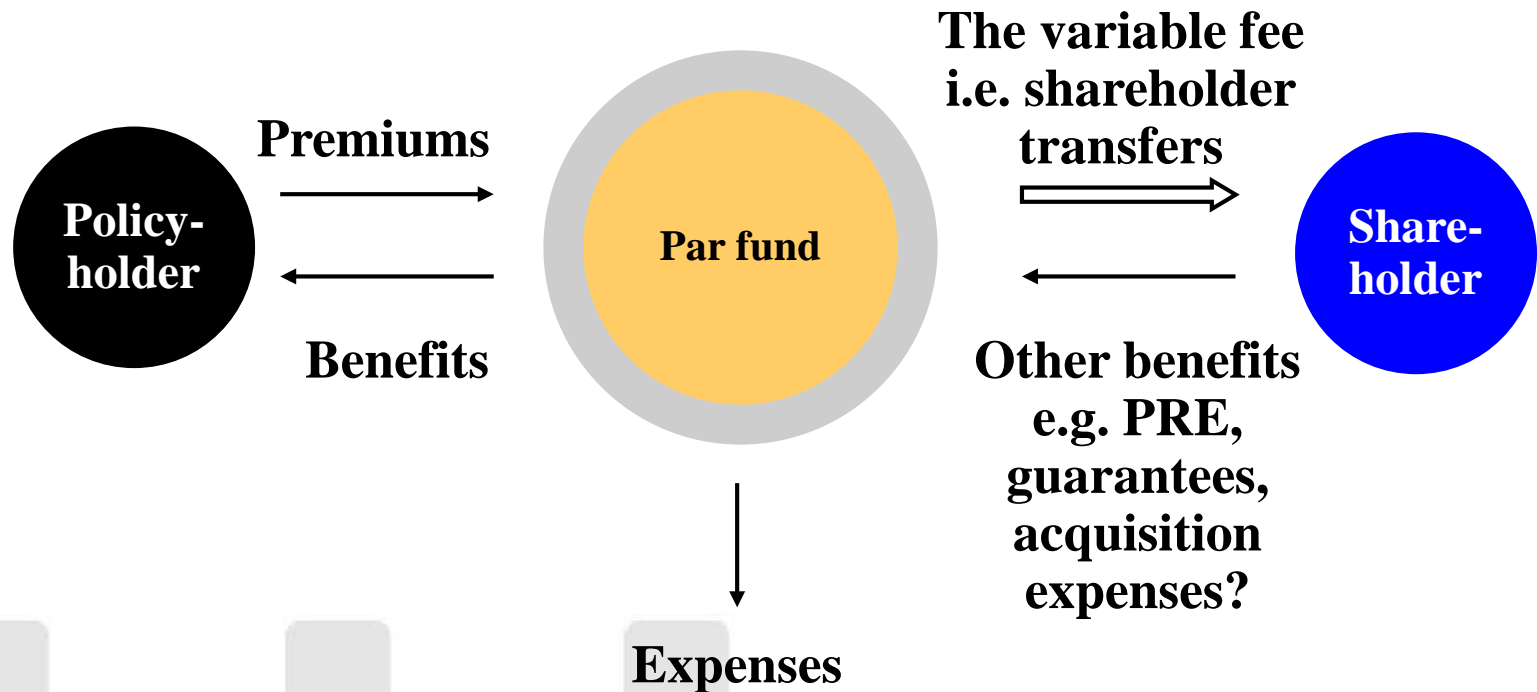


How does par typically operate under our existing regime?

- Relatively **smooth emergence of profit** each year, as insurers typically try to maintain a stable level of bonus. **Experience variances are usually spread out** over future bonus declarations
- Short term volatility typically either not recognised (book value valuation) or **absorbed by the FFA or liabilities**
- Can have 'spikes' when terminal bonuses are declared



# Does VFA for par even make sense?



# Definition of direct participation



**IFRS17.B101** 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. Hence, they are defined as 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** ....

## B101 a) Identifying the items

IFRS 17.B101(a) the **contractual terms** specify that the policyholder participates in a share of a clearly identified pool of **underlying items** ....;

**IFRS 17.2** ... Contractual terms include all terms in a contract, **explicit or implied** ..... Implied terms in a contract **include those imposed by law or regulation**.

We may be able to identify the underlying items with reference to our regulatory requirement to maintain a ring-fenced par fund, where surpluses are shared in the ratio 90:10

# What is the underlying?

**IFRS17.B106** The pool of underlying items referred to in paragraph B101(a) can comprise any items, for example a **reference portfolio of assets**, the net assets of the entity, **or a specified subset of the net assets of the entity**, as long as they are clearly identified by the contract. An entity need not hold the identified pool of underlying items.

**IFRS17.BC245** ....The Board decided the underlying items **do not need to be a portfolio of financial assets....**

.....seems to be quite an open definition!!

# Example of B101(b) assessment



	Policy year			PV(@10% p.a.) at t=0
	1	2	3	
Opening asset share	-	103	215	
Premiums (A)	100	100	100	274
Expenses (B)	5	5	5	14
Risk charge deducted (C)	1	1	1	3
Investment income (10 % p.a.) (D)	9	20	31	48
Shareholder transfer (10% of surplus, E)	0	1	2	3
Closing asset share	103	215	338	
PV of fair value returns (F = D)				48
PV of policyholders share (G = F - B - E)				31
Share of fair value returns to policyholder (G / F)				65%

# What is the underlying?

Two schools of thought:

- Underlying items are simply the assets of the par fund – so that the fair value return on the underlying items is nothing but the investment return on those assets
- Underlying items are all forms of surplus – so that the fair value return on the underlying items includes investment returns, but also profits from mortality, expenses, lapsation etc.

Depending on your view – the assessment of B101 may change

# Example of B101(b) assessment



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PV of policyholders share ( $G = F - E$ )				31
Share of fair value returns to policyholder ( $G / F$ )				90%

# Example of B101(c) assessment



Also seem to be two schools of thought

- Under participating contracts, if the underlying fair value changes by an amount  $A$ , then the policyholder's return increases by  $90\% \times A$ . Therefore B101(c) may be satisfied (assuming guarantees have not bitten – see next slide).
- A further condition may be tested - whether the amount of benefit that is variable is a substantial portion of the overall benefits given to the policyholder. If bonuses are a small component of overall benefits, then B101(c) is not satisfied.



# Adjustments to the assessment



There are some implicit assumptions used to establish:

“Policyholders return = Return on assets less some deductions”

Assumption	Relevant part of the standard
Guarantees have not bitten	IFRS17. B107 – Need to assess on a probability weighted basis
We are targeting to deliver asset share (or something similar) to policyholders	IFRS 17.B103/B68 –Need to reflect mutualisation in our assessment

# Assess probabilistically

IFRS 17.B107 ...An entity shall...assess the variability in the amounts in paragraphs B101(b) and B101(c): ... on a **present value probability-weighted** average basis, not a best or worst outcome basis....

Scenario	Share of fair returns passed to policyholders	Probability of scenario
Return on assets exceeds guaranteed benefits	90%	1-p
Return on assets is less than guaranteed benefits	0% - benefits are fully guaranteed	p

# Assess probabilistically



Probability guarantee bites (p)	Share of fair returns passed to policyholders	B101 (b) /(c) satisfied?
5% - “low guarantee”	$90\% \times (1-p) + 0\% \times p = 86\%$	Yes?
50% - “high guarantee”	$90\% \times (1-p) + 0\% \times p = 45\%$	No?

# Mutualisation



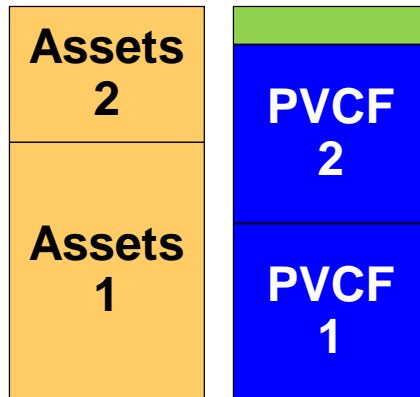
**IFRS17.B68** .... The fulfilment cash flows of each group reflect the extent to which the contracts in the group **cause the entity to be affected by expected cash flows**, whether to policyholders in that group or to policyholders in another group. Hence the fulfilment cash flows for a group:

(a) include payments arising from the terms of existing contracts to policyholders of contracts in other groups, **regardless of whether those payments are expected to be made to current or future policyholders**; and

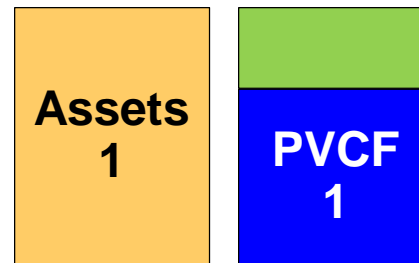
(b) exclude payments to policyholders in the group that, applying (a), have been included in the fulfilment cash flows of another group.

# Mutualisation

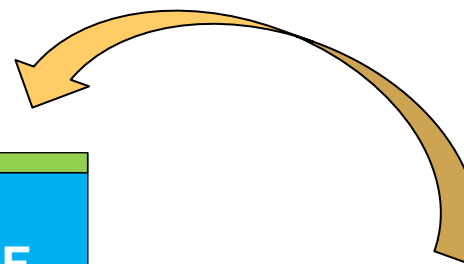
Portfolio



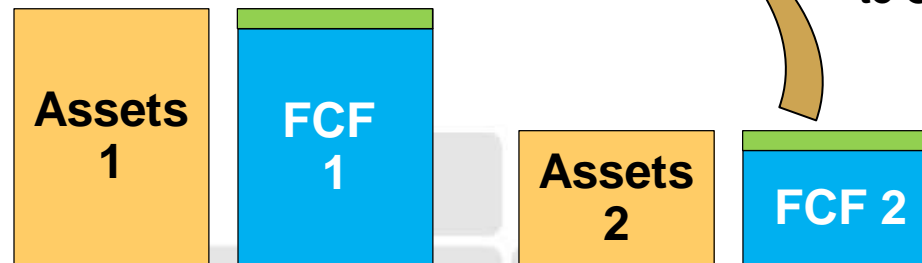
Contract 1



Contract 2



Move cashflows  
from Contract 2  
to Contract 1

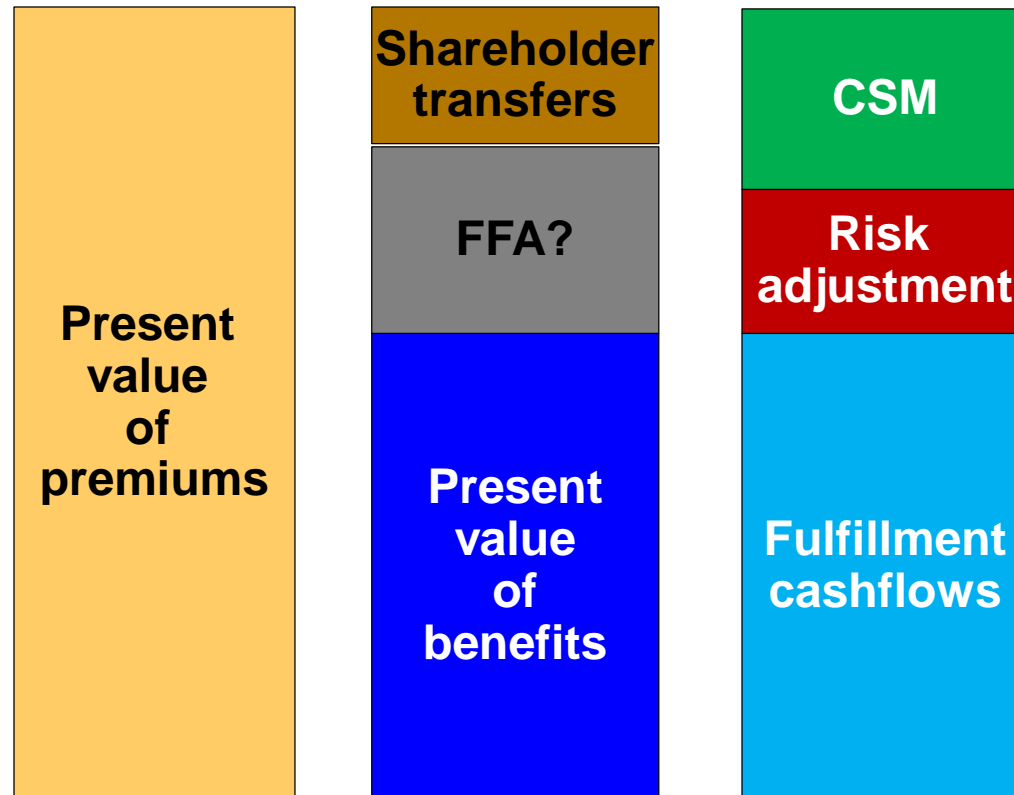


# Example of B101(b) assessment



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# How does measurement stack up?



# Conclusions



- B101(a) – Need to be careful about what's included in the underlying items.
- B101(b)/(c) – depend heavily on our bonus mechanism (and the link to asset shares) and our definition of underlying
- It is very possible that par contracts with different features (say high guarantees and low guarantees) would be measured under different models – is this a problem for users of financial statements?
- Need to define 'substantial' share
- Mutualisation of cash flows creates a headache!