

**Ordine degli Attuari**

**Position Paper**

**IFRS17 - Fair Value Approach**

**June 2021**

## 1. Purpose of this paper

This paper explores the Fair Value Approach at transition trying to supply answer on why it provides a Contractual Service Margin, for portfolios of contracts which are usually deemed to be onerous, instead of a Loss Component.

## 2. IFRS17 standard

### C20

To apply the fair value approach, an entity shall determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as the difference between the fair value of a group of insurance contracts at that date and the fulfilment cash flows measured at that date [1]. In determining that fair value, an entity shall not apply paragraph 47 of IFRS 13 *Fair Value Measurement* (relating to demand features) [2]

### C21

In applying the fair value approach, an entity may apply paragraph C22 to determine:

- how to identify groups of insurance contracts, applying paragraphs 14–24 [3],
- whether an insurance contract meets the definition of an insurance contract with direct participation features, applying paragraphs B101–B109 [3b], and
- how to identify discretionary cash flows for insurance contracts without direct participation features, applying paragraphs B98–B100 [3c].

### C22

An entity may choose to determine the matters in paragraph C21 using:

- reasonable and supportable information for what the entity would have determined given the terms of the contract and the market conditions at the date of inception or initial recognition, as appropriate; or
- reasonable and supportable information available at the transition date [1].

### C23

In applying the fair value approach, an entity is not required to apply paragraph 22, and may include in a group contracts issued more than one year apart [4]. An entity shall only divide groups into those including only contracts issued within a year (or less) if it has reasonable and supportable information to make the division. Whether or not an entity applies paragraph 22, it is permitted to determine the discount rates at the date of initial recognition of a group specified in paragraphs B72(b)–B72(e)(ii) and the discount rates at the date of the incurred claim specified in paragraph B72(e)(iii) at the transition [5] date instead of at the date of initial recognition or incurred claim.

### C24

In applying the fair value approach, if an entity chooses to disaggregate insurance finance income or expenses between profit or loss and other comprehensive income, it is permitted to determine the cumulative amount of insurance finance income or expenses recognised in other comprehensive income at the transition date:

- a) retrospectively—but only if it has reasonable and supportable information to do so; or
- b) as nil—unless (c) applies; and
- c) for insurance contracts with direct participation features to which paragraph B134 applies—as equal to the cumulative amount recognised in other comprehensive income from the underlying items [6].

### 3. Fair value

IFRS13 defines “fair value” the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.

We are interested on the 3 underlined features:

- The price i.e. the exit price
- The transfer of liabilities, i.e. the technical provisions
- The measurement date, that is January 1<sup>st</sup>, 2022 in case first application is on January 1<sup>st</sup>, 2023.

### 4. Methodology

[1] The fair value approach (briefly FVA) should be based on the margins achieved when pricing new business. The Contractual Service Margin equates the difference between the fair value and the actuarial reserves (i.e. the fulfilment cash flows under IFRS17) given by sum of the Present Value of Future Cash Flows (briefly PVFCF) with the risk adjustment (briefly RA) at 1/1/2022, that is the transition date.

[3] The portfolios subject to FVA are composed to similar contracts applying paragraph 14-24, however [4] without the need to split them in annual cohorts.

[3b], [3c] In doing so, care should be taken for the identification of participating contracts eligible to Variable Fee Approach (briefly VFA) and other contracts with participating features.

[1], [5] The underlying data and information, such as the discount rates, could be those updated at the transition date rather than at the inception of the contracts.

Thus, for contracts under the general model (briefly GM), it's necessary to determine the locked-in discount rate used for CSM interest accretion and CSM unlocking for changes in fulfilment cash flows relating to future service at the transition date, instead of the date of the initial recognition.

[2] In determining fair value, entities apply the requirements of IFRS 13 excluding the deposit floor. This means that insurance contract liabilities can be measured at an amount lower than the discounted amount repayable on demand.

Contracts subject to VFA, whose assets and liabilities have been eventually classified at Fair Value Through Other Comprehensive Income rather than at Fair Value Through Profits and Losses, could compute the cumulative amount of interests accreted on fulfilment cash flows at the transition date (i.e. the insurance finance expense) as the

cumulative amount recognized in OCI from the corresponding underlying items, provided that it holds the underlying items [6].

## 5. Margins achieved when pricing new business

The fair value methodology could be different across players since it shall be consistent with the way as they determine profits net of cost of capital (margins) when launching insurance products.

Using a common field shared in EU (where Solvency II is applicable), the fair value might be achieved by measuring

- (a) the cost of setting Solvency II technical provisions *plus***
- (b) the total return on capital that a market participant would expect.**

### 5a. Cost of setting technical provisions

The main component is represented by the Solvency II best estimate (briefly BEL thereafter) added by (a2) the cost of set-up and release of Solvency II risk margin. Solvency II best estimate needs to be amended to reflect the IFRS17 contract boundaries, if any difference is applicable for the portfolio of contracts.

The cost of set-up and release the risk margin is achieved as difference between the point in time risk margin and the present value of its annual release in run – off. It provides a positive amount unless the discount rates are significantly negative for long time.

However, that present value makes usage of discount rates adjusted by the cost of capital rate, if this is applied in pricing profit test.

There are other two components:

In case of transitional on technical provisions is applicable, (a3) the difference between the transitional and the present value of its annual release shall be deducted.

In case real world economic assumptions are used in pricing (profit test), (a4) the spread margin shall be deducted. The spread margin is proportional to the expected additional investment income in run – off in excess to the risk free.

In practise, for contracts with discretionary participation features, the evaluation of spread margin needs to run

- the best estimate with real world assumptions and compares the relevant expected Present Value (briefly PV) of future profits
- against the PV future profits under the run consistent with the EIOPQ risk free rates + the volatility adjustment (or alternatively, the matching adjustment if used for Solvency II evaluations).

The result could be immaterial if financial guarantees are low and the excess of returns of underlying assets is entirely allocated to the policyholders through the contractual clause of revaluation (promised bonus rates).

## 5b. Total return on capital

The return on capital required by a market participant (b1) is achieved by multiplying the minimum return on capital with the PV of SCR in run – off.

The SCR is the same result achieved by either standard formula or internal model, with allowances for both diversification – including that earned as member of a wider Group – and, by contrast, for the risk appetite (defined at level of Group for consistency, if any).

The discount rate should include the Cost of Capital rate for consistency.

The SCR allows for all risks the portfolio is exposed to.

The cost of capital rate is the same as used for pricing similar products at the transition date. It would range between 5% and 8% at time being.

## 6. CSM at transition

CSM at transition date “t” may be shown as the result of the following equation:

$$CSM_t = (BEL - PVFCF) + (b1 - RA) + [a2 - (a3 + a4)] \quad [A]$$

For understanding the reason why it appears >0 in plenty of applications - irrespective of the portfolio is profitable or onerous - let us look at the 3 different terms of the equation:

The first term expresses the difference between two best estimates, i.e. the SII vs the IFRS17.

Given they are using the same contract boundaries, the key differences make the SII BEL higher than the IFRS17 PVFCF.

Key differences are:

- The discount rate which is likely to be higher under IFRS17 than in SII. That's true in case of usage of Top – down in IFRS17 as well as in case of bottom – up: although the bottom up might share the same risk free base curve with SII, its liquidity premium is likely to be higher than SII Volatility Adjustment.
- The perimeter of recurrent expenses in IFRS17 PVFCF are limited compared those in scope in SII BEL.

The second term expresses the cost of capital compared to the IFRS17 Risk Adjustment (RA).

The RA is calculated using statistical inference and requires the setting of confidence level under the discretion of the legal entity.

Compared to the risk margin, the key differences between the RA net of reinsurance and the risk margin are mainly four:

1. The time horizon of RA is the run – off of the contracts where each underwriting risk could occur just 1 time; The risk margin assumes instead that the risk is observed within 1 year time horizon whereas each of them could occur every year in run – off.
2. Unlike Risk Margin, RA is not multiplied by the Cost of Capital Rate.
3. The RA rewards the deepness of historical data and its quality, hence risks are calibrated better (i.e. in favour) than in the Standard Formula

4. RA rewards the diversification due to several (independent) policyholders whereas the risk margin depends solely on volumes under exposure such as best estimate and capital at risk.

Notwithstanding those differences, we may assume the entity may calibrate the confidence level for RA in a way (in any case lower than 99.5%) as to match the corresponding SII Risk Margin, even though differences may emerge in any reporting period.

That said, we can continue the analysis by comparing the cost of capital against the risk margin (instead of against the RA).

There are 3 key differences (factors):

- The cost of capital and the risk margin share approximately the level of cost of capital rate (at time being from 5% to 8% the former, 6% the latter). Thus, the net impact depends materially by the choice of cost of capital rate at transition.
- They differ when looking at the risks in scope, as the former allows for the market risks. This 2<sup>nd</sup> factor makes the cost of capital higher than the risk margin.
- The discount rate is more aggressive in cost of capital as it allows for the cost of capital rate.

The outcome of cost of capital is then slightly lower than the risk margin multiplied the proportion of the whole SCR in respect to the underwriting risks plus the counterparty risk plus the operational risk. Thus, this 3<sup>rd</sup> factor makes the cost of capital lower than the risk margin.

We argue that, after having considered the balance of these components, the outcome of (b1-RA) is likely to be more frequently  $> 0$  although could be  $< 0$  for other portfolios.

The third component is less material than the others.

The most important is (a4) which in turns depends on the eventual usage of spread margin.

The spread margin is immaterial for contracts whose financial guarantees are low because any excess of fund return is allocated to policyholders.

However, the old portfolio in the perimeter of FVA could include participating business with important guarantees, ranging from 3% to 4%.

Should those insurance contracts carry huge amount of reserves, albeit under the current economic assumptions the real world returns rarely exceed 4%, this would be sufficient to reduce the cost of guarantees, hence the component (a4) might become important and material to the extent to making nil the total amount of CSM and with the consequent recognition of a Loss Component.

### Own Credit Risk

Prior to end, it's worth noting IFRS13 permits to allow for the "own credit standing", that is the non – performance risk, i.e. the risk that the obligation won't be fulfilled by the seller of the liability.

In doing so, the best estimate being used in equation [A] is reduced by the equivalent probability to default, with a consequent reduction of CSM, all other being equal.

The Solvency II best estimate does not allow for the own credit standing so as its introduction in the evaluation procedure deserves to be carefully checked in advance.

## 7. Contracts expected to fall under the FVA

We expect contracts incepted until the 90's could fall under the FVA. That's due to the poor information the entity has maintained for such old business, with particular focus on annual past cash flows and contribution to profits & losses of the legal entity.

Whilst the Modified Retrospective is a "retrospective by definition" approach, in contrast the Fair Value is a prospective approach where there's no need for the acquaintance of past cash flows.

Thus, where the Modified Retrospective Approach is not feasible, the FVA is the right choice.

The old portfolio is composed mainly by participating contracts which were born in the mid of 80's as well as unit linked sold by insurers since the mid of 90's.

Term insurance were widespread in those years, anyway their duration is typically shorter so that the most part of them has already expired.

The major part of old participating contracts is exposed to financial risks (minimum guarantees ranging between 3% and 4%) and part of them to longevity risks as well.

Financial guarantees were typically applied as technical rates; as such, they are periodically consolidated and granted until maturity or death and even in case of surrender, albeit with application of few charges.

In other cases, the financial guarantees have been allocated through granted bonus rates, instead of via technical rates. If so, the old contracts have been keeping the characteristic to yearly consolidate that financial guarantees.

The discretionary participation features stand for periodical bonus rates which, despite not granted in advance, they cannot be withdrawn once recognised to policyholders. They depend on the most recent financial result of the underlying assets, excluding unrealised gains and losses.

Those participating contracts have all considered profitable at time when they have been launched, because the financial returns of the underlying assets have been beyond 6% - 7% for long time until year 1997.

Guaranteed annuity options were frequently based on the outcomes of census 1971, considered appropriate until the end of 80's and, in any case, there was statistical evidence that only few policyholders opted for the life contingent annuity at the end of accumulation period.

With the current insight, those old participating contracts are deemed onerous and their liabilities are often supported by additional provisions in local GAAP since long time ago.

The application of Modified Retrospective (MRA) or the Full Retrospective (FRA) approach under IFRS17 would easily result in a Loss Component. In case they would be included in a wider younger portfolio (not onerous with the insight), they would surely contribute to drop down the overall CSM.

However, the eventual lack of historical evidence and of statistical data about the past yearly actual cash flows makes the effort of MRA too hard to achieve and then the choice of FVA becomes more appropriate.