

Ordine degli Attuari

Position Paper

IFRS17 -CSM financial profit recognition

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## 1. IFRS 17 Background

### 1.1. FCF and CSM main features in a nutshell

1. IFRS17.32 requires the entity to measure a group of insurance contract (GIC) at initial recognition as the sum of fulfillment cash flows (FCF) and contractual service margin (CSM).

2. IFRS17.38 outlines:

IFRS17.38 *The contractual service margin is a component of the asset or liability for the group of insurance contracts that represents the unearned profit the entity will recognise as it provides insurance contract services in the future. An entity shall measure the contractual service margin on initial recognition of a group of insurance contracts at an amount that [...], results in no income or expenses arising from:*

- a) the initial recognition of an amount for the fulfilment cash flows [...]*
- b) any cash flows arising from the contracts in the group at that date [...]*

3. In measuring FCF an entity shall:

IFRS17.33 [...]

- a) incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows [...]. To do this, an entity shall estimate the expected value (i.e., the probability-weighted mean) of the full range of possible outcomes.*
- b) reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices for those variables.*
- c) be current—the estimates shall reflect conditions existing at the measurement date, including assumptions at that date about the future [...].*
- d) be explicit—the entity shall estimate the adjustment for non-financial risk separately from the other estimates [...].*

4. Therefore, among others, IFRS 17 is requiring market consistency in measuring FCF. This has to be reflected in underlying calculation assumptions, such as financial assumptions. Indeed, features here below reported of discount rate under IFRS 17 are introduced in paragraph IFRS17.36:

IFRS17.36 [...]

- a) reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;*
- b) be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and*
- c) exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts.*

5. Consequently, IFRS 17 does allow for the application of an illiquidity premium on top at the risk-free rates in order to capture the illiquidity characteristics of insurance contracts. This premium helps in reducing the profit back-loading issue, but it is not sufficient to adjust the whole bias generated.

6. It is worthwhile to note that, under the Variable Fee Approach (VFA), any FCF variances identified over the subsequent measurements adjust the CSM (if any), as stated in IFRS17.43 and subsequent. Therefore the Standard defines:

IFRS17.43 *The contractual service margin at the end of the reporting period [...] as the profit in the group of insurance contracts that has not yet been recognised in profit or loss because it relates to the future service to be provided under the contracts in the group.*

7. Consequently, IFRS 17 foresees as main contributor to P&L result the CSM release of the period; the latter shall be determined according with coverage unit pattern. Here below key IFRS 17 passages on the topic:

IFRS17.B119 *An amount of the contractual service margin for a group of insurance contracts is recognised in profit or loss in each period to reflect the insurance contract services provided under the group of insurance contracts in that period [...]. The amount is determined by:*

- a) *identifying the coverage units in the group. The number of coverage units in a group is the quantity of insurance contract services provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage period.*
- b) *allocating the contractual service margin at the end of the period (before recognising any amounts in profit or loss to reflect the insurance contract services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future.*
- c) *recognising in profit or loss the amount allocated to coverage units provided in the period.*

IFRS17.BC283A *In June 2020, the Board amended IFRS 17 to: [...]*

- b) *clarify that an entity is required to identify coverage units for insurance contracts with direct participation features considering the quantity of benefits and expected period of both insurance coverage and investment-related service [...]*

IFRS17.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.*

## 2. CSM profit recognition – Profit back-loading issue

### 2.1. Market consistent valuation of insurance liabilities

8. As reported in, among others, paragraph 36, B48 and B78 of IFRS 17, the estimation of discount rates should be based on a market consistent approach leveraging on observable market prices and shall include only relevant factors, i.e., factors that arise from the time value of money, the characteristics of the cash flows and shall not contradict any available and relevant market data. This implies to measure the value of option and guarantees in life participating business using specific techniques granting consistency with observable market prices.
9. For instance, this might be achieved using one of the following methods also reported within the Exposure Draft of the Proposed International Actuarial Note (IAN) 100 on Application of IFRS 17 Insurance Contracts:

- a. **Risk-neutral scenarios:** in this technique, the stochastic projected average investment returns on the financial underlying items are calibrated to be consistent with the deterministic risk-free discount rate (with an adjustment for illiquidity as appropriate in order to capture the liquidity characteristics of insurance contracts). This is the approach currently used for Solvency II (SII) (risk free with the consideration of either the volatility or the matching adjustment) and is the most spread over the insurance market to measure insurance liabilities;
- b. **Real world scenarios:** the financial underlying items are projected on a stochastic real-world basis. The discounting is done with a stochastic real-world deflator set, which is a set of interest rates that ensures the same valuation outcome as using risk-neutral scenarios. This approach would allow to include the market risk premium in discount rates (avoiding credit risk) but would imply a change of the logic underlying current actuarial systems used under SII; additionally, no consolidated best market practice is in place under this scenario because of a significant degree of freedom in defining the risk premium to be considered;
- c. **Replicating portfolio techniques:** IFRS17.B46 states that if a replicating portfolio exists for some of the cash flows that arise from a group of insurance contracts, the entity can use the fair value of those assets to measure the relevant fulfilment cash flows instead of explicitly estimating the cash flows and discount rate.  
This approach does not properly take into consideration life underwriting risks. In many cases, it would require the implementation of new systems to determine insurance liabilities and calibrate the replicating portfolio.
- d. **A closed form solution** might also be used where this exists depending on the nature of non-linear dependence. This approach is not appropriate in case insurance contracts embed complex financial guarantees

10. From a theoretical perspective, in a market consistent framework, the price of an insurance contract is unique and is independent from the technique used to calculate it. Indeed, all these techniques should lead to the same outcome. However, driven by Solvency II, the Italian insurance market is going to apply a risk-neutral approach to measure IFRS 17 insurance liabilities, whereas the illiquidity adjustment could be calibrated on the effective asset and liability portfolio, taking into account the illiquidity characteristics of underlying insurance contracts.
11. Consequently, as a matter of fact, under these assumptions IFRS 17 does not allow for considering the whole real-world future investment return the insurer is going to earn from contracts with direct participation features.

#### CSM release under IFRS 17

12. IFRS17.44(e) (for insurance contracts without direct participation features) and IFRS17.45(e) (for insurance contracts with direct participation features) require the CSM to be adjusted for *the amount recognised as insurance revenue because of the transfer of insurance contract 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.*
13. IFRS 17 is not prescriptive regarding how to recognize the CSM in profit or loss. Paragraph B119 of IFRS 17 requires an amount of the CSM for a group of insurance contracts to be recognized in profit or loss in each period to reflect the insurance contract services provided under the group of insurance contracts in that

period. That amount is determined by identifying the coverage units in the group, allocating the CSM to P&L according to each coverage unit provided in the current period and expected to be provided in the future.

14. The determination of coverage units requires the application of judgement to achieve a release of CSM during the years in a systematic and rationale way.
15. For contracts expected to be classified as contracts with direct participation features, such as Italian Segregated fund or Insurance Unit linked business, services that an entity provides to a policyholder are mainly related to the management of underlying items (investment-related service).
16. Consequently, volume based indicators (e.g. assets under management) can be used to estimate the coverage units for contracts with direct participating features. Being a simple and practical solution, we observe that the Italian market is going to apply volume-based coverage units for releasing CSM for direct participating business.

## 2.2. Systematic profit back-loading for direct participating business

17. As reported in previous paragraphs, ISOA expectation is that for direct participating business a market consistent risk-neutral approach<sup>1</sup> will be applied for fulfillment cash flows calculation and volume-based coverage units will be considered for CSM release.
18. This approach leads to two risk allowances for financial risk causing a mismatch between the service provided by the insurer during the period and the profit recognised in P&L through the CSM release that is driven by volume-based coverage units. These two risk allowances are due to:
  - a) **The risk-neutral discount rates.** The IFRS 17 projection curve does not consider the real-world future investment return of underlying items that, on the contrary, includes a market risk premium. Generally speaking, for any given reporting period or even throughout the whole contract duration, an insurer could compare:
    - i. the risk-neutral IFRS 17 projected investment return embedded in the fulfillment cash flows projection (e.g., 0.1%),
    - ii. the real-world investment return expected to be earned, i.e., a real-world expectation of the pool of the underlying items performance without any IFRS 17 constraints (e.g., 1.0%),
    - iii. the actual return the pool of the underlying items has performed (e.g., 1.3%); the actual return could differ from point 18 a) ii. for instance, because of market unexpected developments, different assets management strategies, etc.

Therefore, year by year the CSM would be inflated (because of the VFA mechanism - the change in entity's share of the underlying items) by:

- i. a *systematic (or expected) variance*, namely the difference – CSM wise – between a)ii and a)i above (i.e., the impacts – considering assets and liabilities movement – due to the acknowledgement of the 1.0% instead of the 0.1%),
- ii. a *non-systematic (or unexpected) variance*, namely the difference – CSM wise – between 18.a).iii and 18.a).ii (i.e., the impacts – considering assets and liability movement – due to the acknowledgement of the 1.3% instead of the 1.0%)

<sup>1</sup> Although this paragraphs is based on the assumption of measuring liabilities under a risk-neutral approach, we highlight that the same issue described in this paragraph would emerge also in case any other market consistent technique is taken into account (e.g. real-world deflator approach). The cause of the issue relies on the market consistency IFRS 17 requirements rather than the liabilities measuring technique.

Both these two elements would be therefore deferred over the remaining contract duration if no correction is considered. Hence, in case a strict application of coverage units (e.g., using a volume measure) is applied, this would result in a continuously pushing profits expected to be recognised in previous periods (the systematic variance part)<sup>2</sup> toward the end of the contract life duration.

b) **The Time Value of Options and Guarantees (TVOG)**, which represents the component of PVFCF that reflects the volatility of policyholder cash flows in the presence of options and guarantees. As per IFRS17.B113, change in TVOG occurred in the period adjusts the CSM; however, similarly to what outlined over the previous paragraph, TVOG movement could be split in:

- i. a *systematic (or expected) variance*, generally linked to the concept of unwinding and expected release of the period,
- ii. a *non-systematic (or unexpected) variance*, generally seen as the residual changes in TVOG amount (e.g., due to change in economic environment).

Consequently, these effects would be amortized over the remaining contract duration, in line with the coverage units, therefore shifted towards the end of the coverage period. This bias could provide for a profit deferral effect as well, that should be avoided.

19. Both systematic variances mentioned above are part of the so-called *systematic profit back-loading issue (or Bow-Wave effect)* and generates a bias in the recognition of profit under IFRS 17 for direct participating business compared to the real investments and insurance services provision of these contracts that would systematically occur at each reporting period. It is worth to mention that, on Unit-Linked business the back-loading mechanism is less significant compared to other products (unless specific guarantees are biting).
20. Please note that the non-systematic variance, instead, is not intended to be considered as part of the profit back-loading issue, being an unexpected variance occurred (in some circumstances, potentially caused by a strategic choice of the entity as well).

### 3. Possible solutions to profit back-loading issue

21. As mentioned in previous paragraphs, the profit back-loading issue is mainly caused by IFRS 17 market consistent requirement combined with the usage of a volume based coverage units pattern for CSM release. However, IFRS 17 clearly states that CSM profit recognition should arise in line with services provided in the period through the application of a rationale and systematic allocation mechanism.
22. In this direction, ISOA believes that it is not in IASB intention to produce such a bias in profit recognition according with, among others, IFRS17.B119 and IFRS17.BC282 reported in section 1 of this paper; indeed, those passages outline the requirement of an equal CSM allocation to the coverage units as well as the judgement an entity has to apply in identifying the proper amortization driver.
23. Different methods are under discussion to solve the profit back-loading issue, such as:
  - a) adjust the coverage units by means of a proper discounting method with the objective to offset risk allowance effects due to market consistency IFRS 17 requirement,
  - b) re-calibrate coverage units to be released in the period according with the identified back-loading effect,
  - c) identify an additional element to adjust the CSM release of the period by means of an additive or a multiplicative component aiming at capturing the systematic variance occurred.

<sup>2</sup> Therefore, the higher is the contractual duration the more the impact stemming from profit back-loading issue could be. Additionally, some considerations around expected future duration on specific contracts (e.g. whole life insurance contracts) could be made.

- 24. Irrespective of the method applied, the technique applied should aim at avoiding systematic variances constantly inflating the CSM over time, namely identifying an adjustment to properly define the CSM release of the period.
- 25. It is worthwhile to note that each solution mentioned in paragraph 23 above has to ensure comparability and auditability of the method applied as well as it has to represent a proper balance between complete resolution of the issue and operational complexity.
- 26. Please find below a graphical representation of the profit back-loading issue. More specifically, underlying contracts object of the example is a participating product Segregated Fund linked with 5 years duration. The contract foresees a single premium (of CU 1,000) paid in advance, invested in a coupon bond asset with a 2.50% coupon rate (representing the only underlying items for the sake of simplicity) and a policyholder participation of 80%.

The following financial assumptions are used to assess the contract:

- a) risk-neutral return of 1.00% flat over the whole projection,
- b) real-world expected return of 2.50% flat over the whole projection (assumed to be also equal to actual change in fair value of the underlying items).

Under this assumption, the insurer expectation is to provide the policyholder with a service that is more or less constant over the contractual duration (therefore coverage units release is expected to be stable as well).

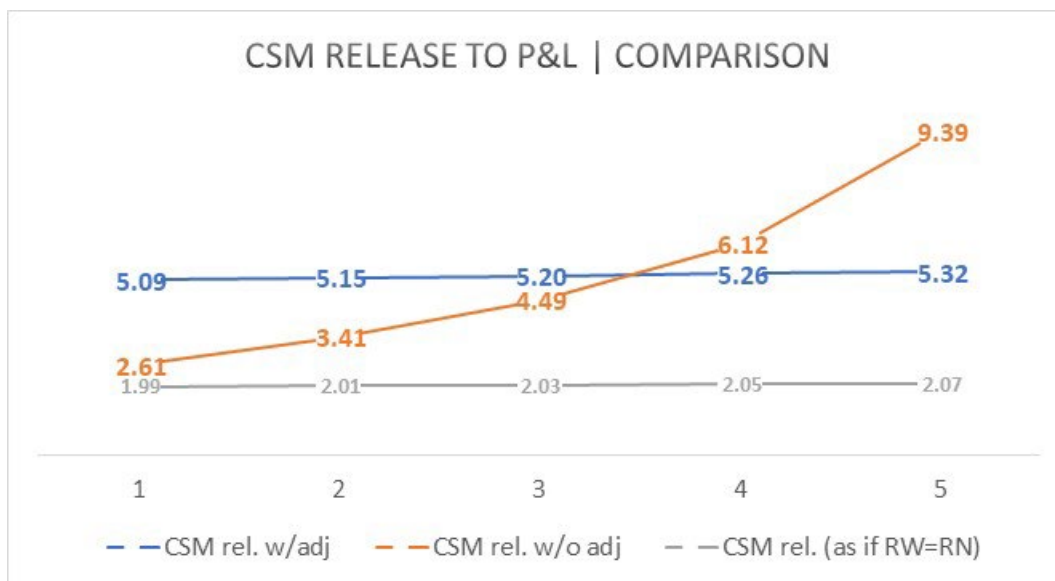


Figure 1 Profit deferral issue example

- 27. Figure 1 above shows as, in case risk-neutral expectation (grey line) would have been met by Real World expectation, the CSM release would result in a quite stable pattern over the years. However, since assets return is systematically higher than expected, applying the very same coverage units pattern (without considering any adjustment), the CSM would be constantly inflated over time ending up with an increasing profit release trend (orange line). Finally, blue line represents a possible CSM release pattern once a practical adjustment has been taken into account (ending up in a very similar trend compared with grey line).

#### 4. Conclusion

28. ISOA believes that CSM profit recognition pattern should be defined in line with the services provided in the period; in this direction, ISOA will continue to follow market best practice development in relation to the issue described in this paper.