STAFF PAPER

June 2018

IASB Meeting

Project	**Insurance Contracts**		
Paper topic	Annual improvement on coverage units		
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Introduction

1. Agenda Paper 2A sets out staff proposals for narrow amendments to IFRS 17 *Insurance Contracts* to form part of the next *Annual Improvements to IFRS Standards Cycle*. This paper discusses an additional proposed amendment in more detail.

2. The objective of the proposed amendment is to clarify the definition of the coverage period for insurance contracts with direct participation features. The proposal arises from a submission to the Transition Resource Group for IFRS 17 (TRG). This paper sets out the staff analysis, the TRG discussion of the submission and the staff recommendations.

Staff recommendations

3. The staff recommend the Board proposes an amendment to the definition of the coverage period for insurance contracts with direct participation features in the next *Annual Improvements to IFRS Standards Cycle*. The amendment would clarify that the coverage period for such contracts includes periods in which the entity provides investment-related services.

4. Proposed wording for the amendment is set out in Appendix A to this paper.

Background

5. An overview of the requirements of IFRS 17 is given in Appendix A of Agenda Paper 2. IFRS 17 requires an entity to recognise the contractual service margin of a group of insurance contracts over the coverage period of the group. The relevant paragraphs of IFRS 17 are shown below.

   (a) paragraphs 44(e) (and 45(e)) of IFRS 17:

      [The contractual service margin is adjusted for] 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.

   (b) the definition of coverage period in Appendix A of IFRS 17:

      The period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.

   (c) the definition of an insured event in Appendix A of IFRS 17:

      An uncertain future event covered by an insurance contract that creates insurance risk.

   (d) paragraph B119 of IFRS 17:

      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 services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). 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 coverage 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 duration.[1]

(b) allocating the contractual service margin at the end of the period (before recognising any amounts in profit or loss to reflect the 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.

6. The TRG received a submission about the definition of ‘quantity of benefits’ in paragraph B119(a) of IFRS 17. This paper addresses questions raised in the submission related to insurance contracts with investment components, in particular whether the quantity of benefits includes investment-related services and whether the coverage duration includes periods in which there is no insurance coverage but there are investment-related services. Examples illustrating the questions are given in Appendix C to Agenda Paper 5 for the May 2018 TRG meeting, which is reproduced in Appendix B to this paper.

7. The staff thinks the analysis of this question differs for insurance contracts without direct participation features (to which the general model applies) and insurance contracts with direct participation features (variable fee approach contracts).

Staff analysis: contracts to which the general model applies

8. The staff think that IFRS 17 is clear that under the general model the quantity of benefits includes only insurance coverage and the contractual service margin is recognised only over the period during which the entity provides coverage for insured events:

[1] The wording of this paragraph would be more consistent with the terminology in the rest of IFRS 17 if it referred to ‘coverage period’ rather than ‘coverage duration’. The staff propose to make that drafting improvement as part of these proposals.

(a) The definition of coverage period refers to the period during which the entity provides coverage for insured events.

(b) Paragraph B119(a) refers to the quantity of coverage and the expected coverage duration. Given this context, the staff think that the only consistent reading of ‘quantity of benefits’ in paragraph B119(a) is benefits of insurance coverage only.

9. The Board acknowledges that some insurance contracts provide services other than insurance coverage: paragraph BC222 of the Basis for Conclusions on IFRS 17 states ‘The key service provided by insurance contracts is insurance coverage, but contracts may also provide investment-related or other services’. However, BC279 of the Basis for Conclusions on IFRS 17 observes ‘Insurance coverage is the defining service provided by insurance contracts’. The focus in these statements on insurance coverage reflects the fact that contracts are in the scope of IFRS 17 because they provide insurance coverage.

10. In determining coverage units, IFRS 17 requires an entity to assess the services provided to the policyholder. For general model contracts, the Board decided that useful information is provided by recognising the contractual service margin in profit or loss over the period in which insurance coverage is provided. Not considering any other service avoids complexity and subjective or arbitrary allocations, and reflects the key service of insurance. [2] The Board decided a different approach to reflect the effect of investment-related services was appropriate only for those contracts that fall within the scope of the variable fee approach (see discussion in paragraphs 13–16 of this paper).

11. The staff acknowledges that for some contracts with insurance coverage that ends substantially before the end of an investment component this approach may seem counterintuitive. However:

(a) Having an investment component does not necessarily imply the entity is providing investment-related services. The general model treats the

[2] If a group of contracts provides different types of insurance cover, the entity will need to compare the benefits provided to policyholders by the different types of insurance cover. But those comparisons are more limited in scope and nature than a comparison of insurance services with other services.

investment component as a financial liability measured at fulfilment value, which is consistent with the treatment of the liability for incurred claims.

(b) The Board was aware that the variable fee approach created a ‘cliff effect’ in the accounting for contracts within its scope and those outside its scope. Based on feedback from stakeholders, the Board concluded that the benefits of the variable fee approach outweighed the added complexity and boundary issues it creates.

12. The staff notes that any change to the definition of the coverage period, or to extend the period used to determine coverage units, under the general model would fall outside the scope of the annual improvements process. The general model consistently separates insurance services from changes in financial effects. Hence making a change would not be a clarification of the wording in IFRS 17 or the correction of relatively minor unintended consequences, oversights or conflicts between existing requirements of Standards. Rather, it would open up fundamental aspects of IFRS 17 and hence would require substantial decision-making. For example, we would have to consider defining which insurance contracts provide additional services and potentially giving guidance on the pattern of recognition of the contractual service margin reflecting those services. The scope of the variable fee approach in IFRS 17 sets the boundary for those contracts that are regarded as providing services similar to asset management services. Defining an additional boundary is likely to be a difficult task, resulting in additional complexity in IFRS 17.

Staff analysis: variable fee approach contracts

13. In contrast to contracts under the general model, IFRS 17 acknowledges that variable fee approach contracts ‘are substantially investment-related service contracts’. This perspective is fundamental to the requirements of the variable fee approach, and to its scope.

14. For example, paragraph BC241 of the Basis for Conclusions on IFRS 17 explains why changes in financial effects not related to the underlying items adjust the contractual service margin under the variable fee approach:

> The Board decided that these differences [in the adjustments made to the contractual service margin applying the variable fee approach and general model] are necessary to give a faithful representation of the different nature of the fee in these contracts. As explained in paragraphs BC228–BC231, the Board concluded that for many insurance contracts it is appropriate to depict the gains and losses on any investment portfolio related to the contracts in the same way as gains and losses on an investment portfolio unrelated to insurance contracts. However, the Board also considered a contrasting view that, for some contracts, the returns to the entity from a pool of underlying items should be viewed as the compensation that the entity charges the policyholder for service provided by the insurance contract, rather than as a share of returns from an unrelated investment. Under this contrasting view, changes in the estimate of the entity's share of returns are regarded as a change in the entity's compensation for the contract. Such changes in the entity's compensation should be recognised over the periods in which the entity provides the service promised in the contract, in the same way that changes in the estimates of the costs of providing the contract are recognised.

15. This paragraph demonstrates that IFRS 17 uses the scope of the variable fee approach to identify insurance contracts that provide investment-related services to an extent that justifies a modified approach to their measurement. The measurement is modified so that changes in the entity's share of the underlying items adjust the contractual service margin. Consistent with this modified measurement, the staff think the consequences of variable fee approach contracts providing such investment-related services are that:

    (a) the references to services in paragraphs 45 and B119 of IFRS 17 should relate to insurance and investment-related services;

    (b) the reference to quantity of benefits in paragraph B119(a) of IFRS 17 should relate to insurance and investment-related benefits; and

    (c) the reference to expected coverage duration in paragraph B119(a) of IFRS 17should relate to duration of insurance and investment-related services.

16. The staff think that the definition of coverage period as the period during which the entity provides coverage for insured events is a barrier to interpreting the references in the way set out in paragraph 15 of this paper. In May 2018, the staff reported to the TRG their plan to recommend to the Board that it propose a narrow amendment to IFRS 17 to modify the definition of coverage period for variable fee contracts to clarify that it includes the period in which investment-related services are provided.

17. The staff think that modifying the definition of coverage period in this way is sufficient for the references noted in paragraph 15 of this paper to be read in the way the Board intended. As explained in paragraph 8 of this paper on the general model, the staff think that references have to be read consistently with the definition of coverage period.

18. Including investment-related services in the determination of coverage units means an entity must assess how both investment-related services and insurance services are provided. This requires an assessment of the pattern of both types of service and their relative weighting. IFRS 17 treats this as a matter of judgement—this should allow good practice to develop.

TRG discussion

19. At the May 2018 TRG meeting, TRG members agreed that the determination of the coverage period and quantity of benefits for variable fee approach contracts should include investment-related services in addition to insurance coverage. In addition, most TRG members argued that the accounting for some insurance contracts under the general model should reflect the provision of services in addition to insurance coverage.

20. TRG members expressed different views on whether it was necessary to amend the definition of coverage period to achieve the inclusion of investment-related services, for both variable fee approach contracts and general model contracts. Those who did not think an amendment is necessary were already reading the definition as including periods in which investment-related services are provided. In support of this view, TRG members pointed to:

(a) The sentence in the definition of coverage period (see paragraph 5(b) of this paper) that refers to *the coverage that relates to all premiums within the boundary of the insurance contract*. [Emphasis added.] Some thought the reference to 'all premiums' implied coverage included any service provided to a policyholder. In contrast, the staff think 'coverage' refers back to 'coverage for insured events' in the previous sentence in the definition.

(b) The references in paragraphs 44, 45, and B119 of IFRS 17 to services and quantity of benefits without the qualifying adjective 'insurance'. As noted in paragraph 8 of this paper, the staff think that the reference in paragraph B119(a) to 'quantity of benefits' has to be read in the context of the references in that paragraph to coverage and the definition of coverage period.

Staff recommendation

21. The staff recommend that the Board proposes a change to the definition of the coverage period for the variable fee approach as part of the annual improvements cycle. We think a change is necessary because we think:

(a) the existing definition of coverage period is a barrier to the inclusion of periods in which there is no insurance coverage; and

(b) clarifying the position for variable fee approach contracts will also clarify the position for general model contracts (see discussion in paragraphs 24(a) of this paper).

22. The Board's *Annual Improvement Cycle* exists for amendments that are limited to changes that either:

(a) clarify the wording in a Standard; or

(b) correct relatively minor unintended consequences, oversights or conflicts between existing requirements of Standards.[3]

23. The staff think that the proposed change meets these criteria.

24. The staff recommend the Board does not consider any change to the definition of coverage period for contracts to which the general model applies because:

(a) the existing definition is clear: the coverage period for contracts to which the general model applies is the period in which an insured event can occur. Amending the coverage period for variable fee approach contracts so that it includes periods in which investment-related services are provided for those contracts will also emphasise the fact that the coverage period for other contracts includes only the period of insurance coverage.

(b) the existing definition reflects the Board's thinking when developing the Standard for contracts to which the general model applies: the contractual service margin is recognised over the period that the service of insurance coverage is provided. The staff think it is unlikely that any change to the Standard in this regard will provide benefits that outweigh the additional costs and complexity inevitably resulting from such a change.

Questions for the Board
Does the Board agree with our recommendation to propose an amendment to the definition of the coverage period for insurance contracts with direct participation features (variable fee approach contracts) in the next *Annual Improvements to IFRS Standards Cycle*? Does the Board agree with our recommendation not to propose any amendment to the definition of the coverage period for insurance contracts without direct participation features (general model contracts)?

[3] Paragraphs 6.11–6.14 of the *Due Process Handbook*.

Appendix A: Proposed amendment to the definition of coverage period

coverage period	For insurance contracts without direct participation features ~~tThe~~ period during which the entity provides coverage for **insured events.** This period includes the coverage that relates to all premiums within the boundary of the **insurance contract**. For insurance contracts with direct participation features, the period during which the entity provides coverage for insured events or investment-related services. This period includes the coverage for insured events or investment-related services that relate~~s~~ to all premiums within the boundary of the **insurance contract**.

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 services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). 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 coverage 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 ~~duration~~.

Appendix B: Examples of insurance contracts with investment components

This appendix reproduces appendix C of Agenda Paper 5 for the May 2018 TRG meeting, which set out examples of insurance contracts with investment components.

Appendix C of Agenda Paper 5 for the May 2018 TRG meeting

Example	**Type of contract**	**Paragraphs**
14	Insurance services and investment component with different durations	C.2–C.5
15	Endowment policy	C.6–C.9
16	Benefit of higher of investment component and multiple of salary	C.10–C.12

C.1 As set out in paragraph 20 of [the May 2018 TRG] paper, the staff think the determination of coverage units is not an accounting policy choice but involves judgement and estimates on how best to reflect the provision of service. In the following examples, the staff comment on whether suggested methods of determining the quantity of benefits and the coverage duration might be valid ways of reflecting the provision of service. Which method gives the best reflection of the provision of service is a matter of judgment that depends on facts and circumstances.

Example 14—Insurance services and investment component with different durations

C.2 Example: an investment contract matures in year 10 and pays the customer the account value at maturity. The contract also includes a death benefit that varies depending on which year in the 10 year period the death occurs. Specifically, if the customer dies during the 1–5 year period, the customer’s beneficiary would receive a death benefit that is the higher of 110 per cent of the premium paid or the accumulated account value (assume the death benefit for years 1–5 results in significant insurance risk). However, if the customer dies in years 6 to 10 the customer’s beneficiary only gets the account value. There is no surrender penalty.

Does the insurer only have to consider years 1 to 5 for determining the coverage units to determine the amortisation of the contractual service margin? Or does the insurer need to consider all 10 years for determining coverage units and amortisation of the contractual service margin?

C.3 Comments on the expected coverage duration [from TRG members' feedback before the May 2018 TRG meeting]:

(a) View A—Years 1 to 5 are the only years in the 10 year period that could expose the insurer to paying an amount higher than the account value due to an insured event. Therefore, the portion of the contractual service margin allocated to the insurance risk portion of the contract is recognized over those five years. The portion of the contractual service margin allocated to the investment management portion will be recognised over the 10 years following the guidance in paragraph 71(c) of IFRS 17.

(b) View B—Paying a death benefit equal to the account value is a benefit payment despite the fact that the insurer is not exposed to a risk of insurance loss. The entire contractual service margin is recognised over 10 years.

(c) View C—Coverage units are defined as insurance units. The insurance coverage is in force in only the first five years. The contractual service margin should be amortised over the first five years. However, the contractual service margin is developed at inception and, as illustrated in Example 6 (IE 56–80) and Example 15 (IE 152–172) in the Illustrative Examples on IFRS 17, contains the present value of the expected spread in establishing crediting rates to the account balance if it is an indirect par policy. Recognising the entire contractual service margin in the first five years would also result in recognising the entire expected spread of the 10-year life over the first five years.

C.4 Comments on quantity of benefits [from TRG members' feedback before the May 2018 TRG meeting]: a practical approach for assessing the quantity of benefits for investment-related services is to use the amount of the investment component in the period, because this reflects the quantity of assets being managed for the policyholder under the contract.

C.5 Staff comments:

(a) if the contract falls within the scope of the variable fee approach:

(i) the contract provides insurance and investment-related services. The coverage period for total services is 10 years.

(ii) the coverage units should be determined reflecting the benefits to the policyholder of the insurance services and the investment-related services. Determining the amount and pattern of the insurance and investment-related services is a matter of judgement. Methods that rely solely on the amount of the investment component or solely on the death benefit would not be a faithful representation of the provision of services.

(b) if the contract does not fall within the scope of the variable fee approach, the contract provides only insurance services for the purpose of applying IFRS 17. The coverage period for those services is the first five years. In years 6–10, the policyholder can make no valid insurance claim and receives no insurance services from the entity.

Example 15—Endowment policy

C.6 Example: the entity has issued conventional participating insurance with the following features:

(a) the policyholder pays a regular level premium to the insurance entity.

(b) in return, the policyholder receives:

(i) insurance coverage, payable upon death of the life insured, of a specified sum insured; and

(ii) a share of the investment returns from an underlying pool of assets to which the policy refers.

(c) the investment returns are allocated to the policyholder through bonuses that are added to the policy's sum insured.

(d) the insurance entity may allocate 'reversionary bonuses' (ie an annual incremental addition to the sum insured) or 'terminal bonuses' (ie an amount in addition to the sum insured and reversionary bonuses that is payable to the policyholder upon maturity or death).

(e) there are three ways in which the policy can terminate. The policyholder could:

   (i) die. In this case the sum insured including all reversionary bonuses accumulated at the time of death and the terminal bonus would be payable.

   (ii) survive and reach the maturity date of the policy. In this case the maturity value consisting of the sum insured, all reversionary bonuses accumulated at maturity and the terminal bonus would be payable.

   (iii) voluntarily surrender their policy before the maturity date. In this case, a surrender value would be payable to the policyholder. The surrender value is generally based on a set schedule such that the surrender value is low in the early years of the policy and increases with policy duration. At maturity, the surrender value equals the maturity value.

A key point of these contracts is that the insurance component of the policy dominates at early durations and the investment component dominates at later durations as the policyholder accumulates investment returns.

C.7 No comments were made [from TRG members' feedback before the May 2018 TRG meeting] about the expected coverage duration (there is insurance risk until maturity of the contract because the surrender value is always lower than the amount payable on death).

C.8 The following methods were suggested for determining the quantity of benefits [from TRG members' feedback before the May 2018 TRG meeting]:

(a) coverage units are determined by reference to the amount payable on death, which reflects the quantity of benefits for both insurance and investment services provided by the entity; and

(b) coverage units are determined by reference to the difference between the amount payable on death and the surrender value, which reflects the quantity of benefits only for the insurance services provided by the entity.

C.9 Staff comments:

(a) for both variable fee approach and general model contracts, the staff think the expected coverage duration is the expected duration of the contract, including expectations of surrender.

(b) for the quantity of benefits, the staff think the analysis differs for variable fee approach and general model contracts:

(i) if the contract falls within the scope of the variable fee approach, the coverage units should be determined reflecting the benefits to the policyholder of the insurance services and the investment-related services. One method of doing this would be by using the amount payable on death (ie including the surrender value). (Same as method in C.8(a)).

(ii) if the contract does not fall within the scope of the variable fee approach, the contract provides only insurance services for the purpose of applying IFRS 17. In principle, the coverage units should be determined by the insurance benefit only, ie excluding the surrender value. (Same as method C.8(b)). However, IFRS 17 does not require entities to separately identify investment components before a claim is incurred, because of the difficulties in doing so.[4] Therefore, the staff think that determining the quantity of benefits by excluding the surrender value is a possible approach if an entity has reasonable and supportable information to do so. If the entity does not have such reasonable and supportable information, it will need to use its judgement to determine the quantity of benefits.

Example 16—Benefit of higher of investment component and multiple of salary

C.10 Example: the entity issues a contract comprising:

(a) an investment linked account; and

(b) an insurance rider which insures payment of five times salary upon death or account balance if greater.

The entity prices for a 10 per cent profit margin in investment services and a 15 per cent return on insurance services. The investment component cannot be separated in applying paragraph 11(b) of IFRS 17 as it is not distinct.

[4] See paragraphs BC10 and BC12 of the Basis for Conclusions on IFRS 17.

There are three ways in which the contract can terminate:

(a) the insured could die. In this case the higher of five times salary and the investment linked account balance are paid at the time.

(b) the insured could reach retirement age. In this case the investment linked account balance would be paid and the contract including any insurance component would cease.

(c) the policyholder could move to another employer and transfer the investment linked balance to another superannuation scheme, which also ceases the insurance cover provided the entity.

A key point of these contracts is that the insurance component of the policy dominates at early durations and the investment component dominates at later durations as the policyholder accumulates investment returns.

C.11 Combined comments on the expected coverage duration and the quantity of benefits [from TRG members' feedback before the May 2018 TRG meeting]:

(a) coverage units should be based on the benefit payable on death—ie the higher of five times salary and the investment-linked account balance, which reflects the quantity of benefits for both insurance and investment services provided by the entity.

(b) coverage units should be based on the difference between the benefit payable on death and the investment-linked account balance, which reflects only the quantity of benefits for only the insurance services provided by the entity. This difference is nil once the investment-linked account balance exceeds five times salary, so the expected coverage duration would end at that point.

C.12 Staff comments:

(a) if the contract falls within the scope of the variable fee approach: the expected coverage duration and quantity of benefits should be determined reflecting the benefits to the policyholder of both the insurance services and the investment-related services. One method of doing this would be by using the sum payable on death, ie including the investment-linked account balance.

(b) if the contract does not fall within the scope of the variable fee approach: the contract provides only insurance services for the purpose of applying IFRS 17. If the investment-linked account is not guaranteed, one way of determining the insurance benefit would be to consider the maximum contractual amount of cover—ie five times salary. If the investment-linked account is guaranteed, or if the insurance benefit is determined by considering the expected amount of a valid claim rather than the maximum contractual amount, in principle, the coverage units should exclude the investment-linked account. However, IFRS 17 does not require entities to identify separately investment components before a claim is incurred, because of the difficulties in doing so[5]. The staff think determining the quantity of benefits by excluding the investment-linked account is a possible approach if an entity has reasonable and supportable information to do so. If the entity does not have such reasonable and supportable information, it will need to use its judgement to determine the quantity of benefits.

[5] See paragraphs BC10 and BC12 of the Basis for Conclusions on IFRS 17.