VFA eligibility assessment for contracts written within a participating insurance fund

Background

1. In Hong Kong, participating insurance contracts are typically written in participating insurance funds. The investment and insurance experiences are shared among contracts written in the same fund. The pool of underlying items for these contracts are the collection of assets within the fund, and the level of non-guaranteed benefits to be paid to policyholders reflects the sharing of the aggregated investment and insurance performance at the fund level. There is no corresponding asset or underlying item that can be identified for each contract.

2. New contracts written in participating insurance funds are required to be classified into contracts with or without direct participation features based on the three criteria described in IFRS 17:B101.

3. For simplicity, the effect of riders that are integrated with base participating contracts are not considered in the discussions below.

Implementation Question

4. At what granularity should the conditions under IFRS 17:B101(b) and IFRS 17:B101(c) be assessed for new contracts written in participating insurance funds?

Technical Reference

5. IFRS 17:B101(a) requires that the contractual terms specify that the policyholder participates in a share of a **clearly identified pool of underlying items.** IFRS 17:B106 mentions that the pool of underlying items can comprise **any items** as long as they are clearly identified by the contract.

6. IFRS 17:B101(b) and IFRS 17:B101(c) require assessments as to the substantiality of the sharing of fair value returns of the underlying items and the degree of variability of cash flows with the underlying items. These are further referred to and elaborated in IFRS 17:B107, which, as clarified by the IASB during its re-deliberations, should be assessed at the **contract level**.

7. Furthermore, IFRS 17:B103 requires that when assessing the criteria under IFRS 17:B101, one should consider the cash flows that the entity expects to pay the policyholders determined applying paragraphs B68–B70, i.e. one should consider the **effect of mutualisation**.

View A

8. The conditions under IFRS 17:B101(b) and IFRS 17:B101(c) shall be assessed at the **participating insurance fund** level. The following sets out one of the arguments of this view.

9. Firstly, IFRS 17:B101(a) requires that a clearly identified **pool** of underlying items be present for each contract. For participating contracts that are written in a participating insurance fund, the pool of underlying items is the collection of assets within the participating insurance fund, which can only be identified for the pool as a whole (i.e. at the fund level)[1]. All the contracts in the fund share in the

[1] IFRS 17:B101(a) does not require that each contract has a separately identifiable underlying item. This is further supported by IFRS 17:B106 which provides examples of underlying items, such as the net assets of the entity, that can only be identified at a higher level than contract level.

experience of the same pool of underlying items (i.e. the pool of underlying items is the same for all contracts) and no corresponding underlying item can be identified for each contract.

10. IFRS 17:B101(b) and IFRS 17:B101(c) then requires the determination of the **fair value returns** on the underlying items. Proponents of this view interprets that the underlying items here should be at the level at which they are identifiable, consistent with the outcome of IFRS 17:B101(a). Since the underlying items in a participation insurance fund can only be identified at the fund level, the fair value returns and hence the cash flows to policyholders can only be determined at the fund level. Therefore, whether or not the fair value returns are substantially shared to policyholders and whether or not a substantial portion of the change in policyholder cash flows varies with the change in fair value returns shall be assessed at the fund level.

11. Proponents of this view acknowledge that there are some other contract types with sharing of returns whose underlying items can be clearly identified at the contract level (e.g. certain investment-linked products). For these contract types, the assessment of the conditions in IFRS 17:B101(b) and IFRS 17:B101(c) are typically assessed at the contract level instead.

View B

12. The conditions under IFRS 17:B101(b) and IFRS 17:B101(c) shall be assessed at the **contract level**.

13. Proponents of this view interprets that IFRS 17:B107 (and other references to "the policyholder" as clarified by the IASB during the re-deliberation) require that the above conditions be assessed at the contract level, and that the cash flows used to assess the above conditions should reflect the mutualisation effect described in IFRS 17:B68-B70, as required by IFRS 17:B103.

14. Given that the underlying items are only identifiable at the fund level, in order to reflect the mutualisation effects and to perform the assessment at contract level, entities would need to either determine the amount of cash flow transfers between contracts in different groups, or to allocate the returns of the underlying items and cash flows determined at the fund level to each contract applying IFRS 17:B68-B70 (as required by IFRS 17:B103). In other words, one cannot directly use the expected non-guaranteed benefits to be paid to each policyholder (after considering the sharing with other policyholders in the fund) in the assessment, because IFRS 17:B68-B70 effectively requires a reversal of the effect of sharing in determining fulfilment cash flows.

15. Proponents of this view note that if cash flows are required to be allocated from fund level to contract level, the determination of an appropriate allocation driver is highly subjective, and the introduction of a notional allocation process may create undue operational burden. Also, the requirement to assess on a probability-weighted average may mean that such an allocation is required for each and every scenario, making the assessment even more operationally challenging.

Excerpts from IFRS 17:

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 (see paragraphs B105–B106);

(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 (see paragraph B107); 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 (see paragraph B107).

B103 To the extent that insurance contracts in a group affect the cash flows to policyholders of contracts in other groups (see paragraphs B67–B71), an entity shall assess whether the conditions in paragraph B101 are met by considering the cash flows that the entity expects to pay the policyholders determined applying paragraphs B68–B70.

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…….

B107 Paragraph B101(b) requires that the entity expects a substantial share of the fair value returns on the underlying items will be paid to the policyholder and paragraph B101(c) requires that 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. An entity shall:

(a) interpret the term 'substantial' in both paragraphs in the context of the objective of insurance contracts with direct participation features being contracts under which the entity provides investment-related services and is compensated for the services by a fee that is determined by reference to the underlying items; and;

(b) assess the variability in the amounts in paragraphs B101(b) and B101(c):

(i) over the duration of the insurance contract; and

(ii) on a present value probability-weighted average basis, not a best or worst outcome basis (see paragraphs B37–B38).

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. However, a clearly identified pool of underlying items does not exist when……

B108 For example, if the entity expects to pay a substantial share of the fair value returns on underlying items, subject to a guarantee of a minimum return, there will be scenarios in which:

(a) the cash flows that the entity expects to pay to the policyholder vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items do not exceed the fair value return on the underlying items; and

(b) the cash flows that the entity expects to pay to the policyholder do not vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items exceed the fair value return on the underlying items.

The entity's assessment of the variability in paragraph B101(c) for this example will reflect a present value probability-weighted average of all these scenarios.

B68 *Sometimes, such contracts will affect the cash flows to policyholders of contracts in other groups. 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.

B69 *For example, to the extent that payments to policyholders in one group are reduced from a share in the returns on underlying items of CU350 to CU250 because of payments of a guaranteed amount to policyholders in another group, the fulfilment cash flows of the first group would include the payments of CU100 (ie would be CU350) and the fulfilment cash flows of the second group would exclude CU100 of the guaranteed amount.*

B70 *Different practical approaches can be used to determine the fulfilment cash flows of groups of contracts that affect or are affected by cash flows to policyholders of contracts in other groups. In some cases, an entity might be able to identify the change in the underlying items and resulting change in the cash flows only at a higher level of aggregation than the groups. In such cases, the entity shall allocate the effect of the change in the underlying items to each group on a systematic and rational basis.*