VFA Focus Group ("VFAFG")

ATT6

- A focus group of the AASB TRG.
- The purpose and function is to provide a forum for communication and to support preparers with VFA specific topics or issues
- Preparers drive problem statements for discussion. If problems are deadlocked, the VFAFG can facilitate discussions with AALC, AASB 17 TRG or IASB staff.

Membership	Role
Resolution Life/AMP, Suncorp, TAL, MLC Insurance, AIA and Zurich	Preparers
Big 4 participants	Provides input
Anne Driver	Chair of the AASB TRG
Tom Moodie	Co-ordinator

Issue/topic	Outputs
Presentation of VFA revenue	Paper tabled at September 2020 AASB TRG
VFA eligibility criteria	Paper discussed - tabled for AASB TRG by preparers
Cohorts required on transition	Paper discussed - tabled for AASB TRG by preparers
Modifications	Paper drafted and shared with participants. Not sharing via the AASB TRG
Mutualisation cash flows	Paper drafted and under discussion
Separation/combination of investment-linked contract with riders	Paper still to be drafted and discussed
Hybrid contracts – Investment-linked with investment account options	Paper still to be drafted and discussed

- Cadence of meetings: Fortnightly beginning 6th August 2020
- More information: Contact Tom Moodie: thmoodie@deloitte.com.au

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AASB Transition Resource Group for AASB 17 *Insurance Contracts*

Implementation question discussed by Variable Fee Approach (VFA) focus group – Cohort considerations on transition

Submission date	22/03/2021
Name	Fred Jorgensen representing VFA focus group
Title	Participant
Organisation	VFA focus group (a working group of the AASB TRG)
Stakeholder group	Industry Group

Implementation question discussed by VFA focus group

The issue considered by the focus group is whether, on transition to AASB 17/IFRS 17, traditional par business (Whole of Life and Endowment) in the Australian and New Zealand markets will in practice be required to be divided into annual cohorts or whether this business will be able to be treated as one cohort.

If the full retrospective approach ("FRA") can be applied on transition to IFRS 17 this would require identification of "groups of insurance contracts" established from original contract inception, including use of annual cohorts. If the FRA is **"impracticable"** to apply, entities may avail themselves of the reliefs under the modified retrospective approach ("MRA") and the fair value approach ("FVA") which include annual cohorts not being required. In the case of the MRA, this is subject to **"reasonable and supportable information"** not being available to apply the MRA by annual cohort.

In situations where the VFA portfolio has been closed for an extended period of time, the FVA is likely to be able to be applied on transition for VFA business, with this business treated as one cohort due to the relief available under this transition approach per IFRS17.C23. Entities will need to document their decision and have this audited as part of pre-implementation activities.

However, each entity must consider the facts and circumstances relevant to its traditional par business, including whether any or all of that business was recently acquired or a specified contract modification under IFRS17.72 has occurred, each of which may lead to the FRA not being impracticable for the associated part of the traditional par business.

Paragraph of IFRS 17 *Insurance Contracts*

Various, including: IFRS 17.22, C3-C10, and C21-C23

Background

In many cases traditional par business and other business for which the VFA may apply has been closed to new business in the Australian and New Zealand markets for an extended period of time – in most cases, for well over 20 years. However, there are still open products in the life insurance and friendly society markets which may qualify for VFA.

FRA

The FRA may be impracticable to apply for any of this business which incepted a significant time ago due to lack of data availability.

A contributor to this thinking is that the FRA requires data for all business in-force at past dates (including business that has since lapsed) not just data at those dates for business still in-force at the transition

date. Past system changes and lack of migration of historical data when those system changes were made will add to the other reasons for lack of data availability at past dates.
Therefore, the period prior to transition during which the FRA is not impracticable to apply may start well after the last date that new contracts of this type were written – in both Australia and New Zealand.

MRA

The MRA may also be unable to be applied for this business, due to the MRA requiring historical cashflow data, including for business that is no longer in force at the transition date, for all of the period since commencement of this business.

For the MRA, IFRS 17.C10 states that an entity can group more than twelve months' worth of business together if it does not have reasonable and supportable information to do otherwise (for example, cashflows split by annual cohorts).

FVA

IFRS 17.C23 specifically states that cohorts are not required under this transition approach. But if cohorts are applied, then this must be based on reasonable and supportable information.

Given the increase in post transition operational complexity of maintaining cohorts for this business and the associated issues relating to applying the "mutualisation" provisions of IFRS 17 (per B67-B71), it is likely that the FVA transition relief will be adopted to not apply the cohort requirement.

Recent events

The above analysis does not hold for contracts that have recently:
- been acquired by the entity (e.g. through a Part 9 transfer of business); or
- undergone modifications that would require new contracts to be recognised had IFRS 17 applied at the time (per IFRS 17.72).

Future events

The above analysis only relates to considerations on transition and does not hold for future acquisitions.

Is the question pervasive?

The issue may impact industry stakeholders issuing contracts with direct participation features.

Cohort considerations on transition – AASB TRG March 2021

Appendix A – IFRS 17 Extracts

IFRS17.22: An entity shall not include contracts issued more than one year apart in the same group.

Full Retrospective requirements (with emphasis):

IFRS17.C3: **Unless it is impracticable** to do so, or paragraph C5A applies, an entity shall apply IFRS 17 retrospectively …
[C5A relates to risk mitigation option & derivatives, reinsurance etc for direct participation contracts.]

IFRS17.C4: To apply IFRS 17 retrospectively, an entity shall at the transition date:
(a) identify, recognise and measure each group of insurance contracts **as if IFRS 17 had always applied**; …

IFRS17.C5: **If, and only if, it is impracticable** for an entity to apply paragraph C3 for a group of insurance contracts, an entity shall apply the following approaches instead of applying paragraph C4(a):
(a) the **modified retrospective approach** in paragraphs C6–C19A, subject to paragraph C6(a); **or**
(b) the **fair value approach** in paragraphs C20–C24B.

Modified Retrospective requirements (with emphasis):

IFRS17.C6: The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible **using reasonable and supportable information available without undue cost or effort**. Accordingly, in applying this approach, an entity shall:
(a) use reasonable and supportable information. If the entity cannot obtain reasonable and supportable information necessary to apply the modified retrospective approach, it shall apply the fair value approach.
(b) **maximise the use of information** that would have been used to apply a fully retrospective approach, but need only use information available without undue cost or effort.

IFRS17.C7: Paragraphs C9-C19A set out **permitted modifications** to retrospective application in the following areas:
(a) **assessments of** insurance contracts or **groups** of insurance contracts that would have been made at the date of inception or initial recognition;

IFRS17.C8 To achieve the objective of the modified retrospective approach, an entity is **permitted to use each modification** in paragraphs C9–C19A **only to the extent** that an entity **does not have reasonable and supportable information** to apply a retrospective approach.

IFRS17.C9 **To the extent permitted** by paragraph C8, an entity shall **determine** the following matters **using information available at the transition date**:
(a) how to **identify groups** of insurance contracts, applying paragraphs 14–24;

IFRS17.C10 **To the extent permitted** by paragraph C8, an entity **shall not apply paragraph 22** to divide groups into those that do not include contracts issued more than one year apart.

Fair Value Requirements (with emphasis):

IFRS17.C21 In applying the fair value approach, an entity may apply paragraph C22 to determine:
(a) **how to identify groups** of insurance contracts, applying paragraphs 14–24;

IFRS17.C22 An entity may choose to determine the matters in paragraph C21 using:

(a) **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
(b) **reasonable and supportable information** available at the **transition date**.

IFRS17.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. 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**.

AASB Transition Resource Group for AASB 17 *Insurance Contracts*

Implementation question discussed by Variable Fee Approach (VFA) focus group – VFA Eligibility

Submission date	22/03/2021
Name	Guy Elliott representing VFA focus group
Title	Participant
Organisation	VFA focus group (a working group of the AASB TRG)
Stakeholder group	Industry Group

Implementation questions discussed by VFA focus group

This note was produced for discussion purposes at the VFA focus group to consider whether Australian participating business can be eligible for the VFA and sets out the focus groups' collective discussion of:

1. the eligibility criteria and the issues and challenges arising in determining VFA eligibility;
2. application at transition; and
3. the potential impact of transfers of insurance contracts and business combinations.

The potential issues and challenges in determining VFA eligibility which were discussed by the focus group and which are outlined in this paper are:

a) What is meant by 'substantial' in B101(b)?
b) How do you evaluate an expectation that a substantial share will be paid?
c) How do you evaluate an expectation that a substantial proportion of changes in amounts payable will vary with change in underlying items?
d) How do you allow for non-homogeneous aspects, e.g. tiered bonus & crediting rate levels?
e) What is the treatment of contracts that can convert to non-participating contracts at a point in their life-cycle?
f) Can you evaluate these expectations retrospectively at transition or is evaluation at transition the only realistic option?

Paragraph of IFRS 17/AASB 17 *Insurance Contracts*

Various, including: AASB 17.B101-B109, C3-5, C8-9, and C21-C22

Background

1. Eligibility Criteria

The eligibility criteria in summary are:

a) the link to the underlying items must be clear, enforceable; and not capable of being changed retrospectively (B101(a), B105 & B106)
b) an expectation (B101(b) & (c), B107 & B108) that:
   (i) the policyholder will be paid a substantial share of the returns on the underlying items; and
   (ii) a substantial proportion of any change in the amounts to be paid to the policyholder to vary with change in fair value of the underlying items;
c) the contract does not qualify as a reinsurance issued or held (B109).

1.1 Link to Underlying Items

For a contract to be eligible for VFA:

a) it must specify a participating share of a clearly identified pool of underlying items (B101(a));
b) the link to the underlying items must be enforceable (B105);
c) the underlying items need not be held, but must be clearly specified (B106); and
d) they are not clearly specified if:
   (i) the underlying items can be changed retrospectively (B106(a)); or
   (ii) there are no underlying items identified.

Most participating business was written back when policy documents were fairly short and participation was often acknowledged very succinctly in the policy document, for example:

> *"This Policy participates in distributions of our profits. These profits will be used to increase your Basic Benefit. These increases are called bonuses."*

> *"This policy is issued with participation in the profits of the Society."*

> *"This policy is issued with participation in the surplus of the Society as allocated from time to time by the Board of Directors of the Society and approved by its Actuary."*

The Life Insurance Act 1995 (Life Act) itself has an extensive set of rules regarding the identification, allocation and distribution of profits attributable to participating business (see Appendix B). We consider that these rules are effectively included in the contractual terms under paragraph 2 of AASB 17. The Life Act creates a clear definition of profit and its allocation for Australian participating business. Prima facie, this could be interpreted that such contracts meet the AASB 17 requirements for a clear link to a pool of underlying items, from at least the time of the Life Act.

We would therefore expect that, for any participating contract issued before the Life Act came into force, either:

(a) the contract met the criteria of B101 at inception; or

(b) the contract came to meet the criteria of B101 at some point between inception and the Life Act;

(c) the contract met those criteria at the effective date of the Life Act (1995), having not done so previously. This means that for this contract we have a specified contract modification under paragraph 72, and the contract as modified by the Life Act is then treated as a new contract issued at the effective date of the Life Act. For this contract, VFA eligibility could then be assessed at the Life Act date.

Therefore, it may be reasonable to assume, a participating contract issued after the Life Act came into force would be expected to meet the criteria of B101 at inception, by virtue of compliance with the Life Act.

Where the issuing entity was a mutual society that subsequently demutualised, policyholders' participation rights would have been further clarified at that time. In particular, if membership rights arose from holding participating contracts, demutualisation could be seen as involving separation of membership rights from the contract in exchange for shares in the demutualised entity. In that case, depending on facts and circumstances, the change to contracts which occurred at demutualisation may qualify as a contract modification under paragraph 72(b), meaning that such contracts could then be assessed at the demutualisation date if they change in definition.

1.2 What is Substantial?

Substantial is to be interpreted in the context of these 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 (paragraph B107(a)).

One of the reasons the IASB gave for rejecting extension of VFA to reinsurance was that VFA was designed specifically so that contracts providing a substantial investment service would be accounted

for similarly to asset management contracts (BC249C). This precludes participating pure risk contracts being eligible for VFA.

There is ongoing debate globally as to how substantial should be determined. One school of thought is that the potential dividing line between substantial and not substantial lies somewhere around 50%. If the evaluations required under B101(b) and B101(c) come significantly above 50% then it can be considered to be substantial. However, if it is close to 50%, a more careful consideration of facts and circumstances is required. There are, however, other perspectives that depending upon facts and circumstances a contract would need a higher proportion than 50% and there are also perspectives that depending upon facts and circumstances a contract with less than 50% could still be substantial.

1.3 Substantial Share (B101(b))

The determination of the expectation for the purposes of B101(b) is:

a) assessed at the contract level not at group of insurance contracts level (B107(b)(i) and BC249D);
b) permitted to be assessed for all contracts in a homogeneous group, based on the assessment of one contract in that group (BC249D);
c) to allow for cash flows to / from other policyholders to the extent that B68-70 apply (B103);
d) to be assessed over the life of the contract on a present value probability weighted expected value (B107(b)); and
e) to reflect all amounts paid to the policyholder from the underlying items (B101(b)).

The question of whether the amounts paid to the policyholder from the underlying items include insurance charges and AUM based fees, was raised in the 'Reporting on other questions' submitted to the April 2019 IASB TRG (see Paper 02, staff Response to S115 including Appendix A - Example 2—Application of paragraph B101(b) of IFRS 17 (which relates to S115)).

The staff response was in summary that:

a) the fair value return on underlying items is determined gross of any AUM based asset management fee (see Appendix A example 2(a)); and
b) the share paid to the policyholder includes the mortality charge as a payment on behalf of the policyholder (see Appendix A example 2(b)).

The discussion at the TRG clarified that this was influenced by whether the fee or charge varied with the fair value of the underlying items. It was noted that the mortality charge was fixed and had the mortality charge varied with the underlying items the view could have been different.

This would appear to reflect a view that where fees and charges vary with the underlying items this is a strong indicator that they are not a separate service to the policyholder but rather a charge for the delivery of the underlying items. Hence the asset management fee is seen as a charge for the investment related service whereas the insurance charge is for separate service which is paid out of the policyholder's share.

A key question that was not discussed at the TRG was whether the assessment of the policyholder share against the fair value return is gross or net of investment taxes. There are two views:

View One - the fair value returns on the underlying items are determined before any investment taxes and this is compared with the expected payments to policyholders out of the net of tax investment return; or

View Two - the comparison of the expected payments to policyholders with fair value returns on the underlying items should be done on a consistent basis. For example, either both items should be net of investment taxes or they should both be gross of such taxes.

View One is partly supported by the April 2019 IASB Staff response and TRG discussion on S115 and Appendix A example 2, in that investment taxes by their nature tend to vary with fair value of underlying items.

View Two is supported by the changes to the Standard made in June 2020 to paragraphs B65 and B66 to explicitly recognise that investment income taxes are inevitably incurred as part of investing for the benefit of policyholders.

It is worth noting that, if the investment tax rate is 30%, the maximum expected payout is 70% of the gross expected investment income. With an 80:20 profit share this reduces to 56%, which would make it very challenging to meet the substantial test under View One.

Thus, an assessment of the entity's expectations per B101(b) involves:

a) forming a view on the appropriate treatment of investment taxes;
b) forming a view based on the facts and circumstances of the contract as to whether there are other separate services present such as the payment of mortality charges which should be included as part of the amounts paid to the policyholder;
c) selecting a basis (or combination of bases) – which may or may not be one of the Views described above – on which to measure the expectations; and
d) assessing expected outcomes across all relevant scenarios, which in light of the reference to paragraphs B37-38 in paragraph B107(b)(ii), is to be across the full range of scenarios, with the present value of cash flows from each scenario weighted by its probability to arrive at an expected present value.

See the April 2019 IASB TRG Paper 02 Submission 115 in Appendix A for a set of worked examples. Summary calculations behind these are included in Appendix C.

1.4 Substantial Proportion (B101(c))

The determination of the expectation for the purposes of paragraph B101(c) involves assessing whether a substantial proportion of any change in the amounts to be paid to the policyholder is expected to vary with the change in fair value of the underlying items in the light of paragraphs B107 and B108.

Unlike paragraph 101(b), this assessment of the change in amounts paid to the policyholder is not against the fair value return on the underlying items but against the change in fair value of the underlying items.

Paragraph B108 makes clear that, where there are guarantees present, a probability-weighted assessment across future scenarios is required. However, it is less clear as to how this assessment is to be done and there are **at least** three possible views. These views were discussed at the focus group:

View One - Of the total amount expected to be paid to policyholders, a substantial proportion varies in some way with the fair value of the underlying items.
For example, if 100 is expected to be paid in total to policyholders, and 50 of that payment varies with the underlying items, the proportion is 50%.

View Two - Of any change in the amount expected to be paid to policyholders, a substantial proportion varies with (or is explained by) the change in underlying items.
For example, if the payment is expected to vary by 40 in a particular scenario and 20 of that change is explained by the change in underlying items, the proportion is 50% in that scenario. The overall proportion is a probability weighted assessment across all scenarios.

View Three - A substantial proportion of any change in underlying items flows into (is correlated with) the change in amounts paid to policyholders.
The correlation is assessed across all scenarios. So, for example, if the policyholder received 50% of the change in underlying items in all scenarios, the correlation would be 100%. If the policyholder received 50% of the change in underlying items in most scenarios but there was no change in the amount paid in the remainder, the correlation would be less than 100%.

The key issue with View One is that it puts the focus on the proportion of "change in amounts paid", rather than on the proportion of "any change in amounts paid" relative to change in underlying items, which is not entirely consistent with wording of B101(c).

View Two, which appears consistent with the words of B101(c) and the IASB Staff response to the simple example in submission 115, focuses on the relationship between any change in amounts paid and the variation in the underlying items.

View Three also appears consistent with the words of B101(c), in that it also measures the linkage between the changes in amounts paid and the changes in the underlying items.

Thus, an assessment of an entity's expectations per B101(c) involves:

a) forming a view based on the facts and circumstances of the contract as to whether there are other separate services present such as the payment of mortality charges which should be included as part of the amounts paid to the policyholder;
b) selecting a basis (or combination of bases) – which may or may not be one of the Views described above – on which to measure the expectations; and
c) assessing expected outcomes across all relevant scenarios, with the present value of cash flows from each scenario weighted by its probability to arrive at an expected present value or correlation.

1.5 Mutualisation

The mechanisms used to distribute profit to participating contracts can provide mutual support across different sub-funds and generations. This feature may need to be taken into account in assessing the eligibility of an individual contract.

2. Transition Considerations

Full Retrospective Approach

If the full retrospective approach applies (i.e. doing so is not impracticable), then the VFA eligibility assessment is done at contract inception based on evidence at that time (paragraph B102).

Modified Retrospective Approach

VFA eligibility assessment may be done as at transition date, instead of contract inception, but only if the entity does not have reasonable and supportable information to make the assessment as at contract inception (paragraphs C8-C9).

Fair Value Approach

As participating business has largely been closed to new business in Australia for many years (decades in the case of conventional business), this is the approach most likely to be used for Australian participating business.

Under the fair value approach (paragraphs C21-C22), the entity has the choice of assessing VFA eligibility at either:

a) the date of contract inception or initial recognition; or
b) the transition date;

provided that it has reasonable and supportable information to do so.

In the case of (a), this means 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.

Note that there is not a 'choice' between contract inception and initial recognition under (a), as IFRS 17 clearly identifies the effective timing of each of the four determinations in C21 e.g. the VFA eligibility test is at inception (B102), while identifying groups of contracts is at initial recognition (paragraph 24). Thus the words "as appropriate" in C22 simply mean "whichever applies to the relevant matter".

If the assessment is to be done as at contract inception, meeting the requirement for "reasonable and supportable information for what the entity would have determined" may be challenging, if reasonable and supportable goes wider than just knowing the contract terms and market conditions as at the date of contract inception.

For example, finding reasonable and supportable information for what would been the entity's view of the full range of scenarios and their distribution as at contract inception in the 1980's, in order to determine expectations for contracts issued at those times.

If the assessment has to be done as at transition date, this likely will mean that contracts that have relatively short periods left to run to maturity will not be eligible for VFA, even though they will still be part of the underlying items, for those that do qualify.

3. Transfers of Insurance Contracts and Business Combinations

For contracts acquired as part of a business combination subject to AASB 3, the acquirer is required to make classifications or designations on the basis of contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they existed at the acquisition date (AASB 3.15). AASB 3.17 currently provides two exceptions to this, one of which allows the classification as an insurance contract to be done at the date of contract inception (or later modification if appropriate). AASB 17 modifies this exception so that it only applies for business acquired no later than the date of transition. All the grouping and recognition requirements of AASB 17 (paragraphs 14 to 24) are applied as if the entity had entered into the contracts at the date of the transaction.

It was recently clarified by IASB staff (January 2021) that a business combination or transfer of insurance contracts (per B93 to B95F) establishes a new inception date – with the resulting implication for the timing of the assessment of VFA eligibility per 3.3.2 – notwithstanding the aforementioned exception for classification as an insurance contract under AASB 3.17.

For contracts acquired as a part of a transfer that does not qualify as a business combination subject to AASB 3, AASB 17:

a) requires them to be treated in same way as those falling under AASB 3 for grouping and recognition (paragraphs 14 to 24); and
b) also allows those that represent a liability for settlement of claims incurred before transfer to be treated as liability for incurred claims in the same way that those falling under AASB 3 may be, if the contracts were acquired prior to transition date (paragraphs C9A and C22A).

This indicates that the intention of AASB 17 is that the grouping, recognition and eligibility for measurement under VFA of acquired contracts should be done as at the date of transaction, except that the nature of the contract is assessed at the date of contract inception as long as the contract was acquired no later than the transition date.

Is the question pervasive?

The issue may impact industry stakeholders issuing contracts with direct participation features who wish to determine if they are eligible for VFA.

VFA Eligibility – AASB TRG March 2021

Appendix A – AASB 17 Extracts

AASB 17 Appendix A Defined Terms

Insurance contract with direct participation features - *An* ***insurance contract*** *for which, at inception:*

(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****.*

AASB 17 Appendix B Application guidance

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).

B102 An entity shall assess whether the conditions in paragraph B101 are met using its expectations at inception of the contract and shall not reassess the conditions afterwards, unless the contract is modified, applying paragraph 72.

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.

B104 The conditions in paragraph B101 ensure that insurance contracts with direct participation features are contracts under which the entity's obligation to the policyholder is the net of:

(a) the obligation to pay the policyholder an amount equal to the fair value of the underlying items; and

(b) a variable fee (see paragraphs B110–B118) that the entity will deduct from (a) in exchange for the future service provided by the insurance contract, comprising:

(i) the amount of the entity's share of the fair value of the underlying items; less

(ii) fulfilment cash flows that do not vary based on the returns on underlying items.

B105 A share referred to in paragraph B101(a) does not preclude the existence of the entity's discretion to vary the amounts paid to the policyholder. However, the link to the underlying items must be enforceable (see paragraph 2).

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:

(a) an entity can change the underlying items that determine the amount of the entity's obligation with retrospective effect; or

(b) there are no underlying items identified, even if the policyholder could be provided with a return that generally reflects the entity's overall performance and expectations, or the performance and expectations of a subset of assets the entity holds. An example of such a return is a crediting rate or dividend payment set at the end of the period to which it relates. In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set, and does not reflect identified 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).

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.

B109 Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of IFRS 17.

AASB 17 Appendix C Effective date and transition

C3 Unless it is impracticable to do so, or paragraph C5A applies, an entity shall apply IFRS 17 retrospectively, except that:

(a) an entity is not required to present the quantitative information . . .; and

(b) an entity shall not apply the option in paragraph B115 . . .

C4 To apply IFRS 17 retrospectively, an entity shall at the transition date:

(a) identify, recognise and measure each group of insurance contracts as if IFRS 17 had always applied;

C5 If, and only if, it is impracticable for an entity to apply paragraph C3 for a group of insurance contracts, an entity shall apply the following approaches instead of applying paragraph C4(a):

(a) the modified retrospective approach in paragraphs C6–C19A, subject to paragraph C6(a); or

(b) the fair value approach in paragraphs C20–C24B.

Modified retrospective approach

C8 To achieve the objective of the modified retrospective approach, an entity is permitted to use each modification in paragraphs C9–C19A only to the extent that an entity does not have reasonable and supportable information to apply a retrospective approach.

Assessments at inception or initial recognition

C9 To the extent permitted by paragraph C8, an entity shall determine the following matters using information available at the transition date:

(a) how to identify groups of insurance contracts, applying paragraphs 14–24;

(b) whether an insurance contract meets the definition of an insurance contract with direct participation features, applying paragraphs B101–B109;

(c) . . .

Fair value approach

C21 In applying the fair value approach, an entity may apply paragraph C22 to determine:

(a) how to identify groups of insurance contracts, applying paragraphs 14–24;

(b) whether an insurance contract meets the definition of an insurance contract with direct participation features, applying paragraphs B101–B109;

(c) . . .

C22 An entity may choose to determine the matters in paragraph C21 using:

(a) 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

(b) reasonable and supportable information available at the transition date.

IASB TRG April 2019, Paper 02

Submission 115

Topic: *Definition of insurance contracts with direct participation features—applying paragraph B101(b) of IFRS 17*

Question:

The submission describes a unit linked insurance contract for which the entity charges an asset management fee determined as a percentage of the fair value of the underlying items at the end of each period plus a premium for mortality cover by reducing the underlying items at the beginning of each period. The submission questions the application of paragraph B101(b) of IFRS 17 in determining whether a contract meets the definition of an insurance contract with direct participation features.

First the submission asks how to determine the share of the fair value returns on the underlying items ignoring the mortality cover. It proposes:

(a) a calculation that compares the share of each party in the fair value returns on the underlying items;
(b) a calculation that results in 100% share to the policyholders in all circumstances; and
(c) a calculation that compares the incremental share of each party in the fair value returns (incremental to a scenario in which the fair value returns are nil).

Then the submission considers whether and how the premium for mortality cover deducted from the underlying items impacts the above calculation.

IASB Staff Answer:

Paragraph B101(b) of IFRS 17 requires that the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items as a condition for meeting the definition of an insurance contract with direct participation features. Therefore, a determination

based on any calculation other than a calculation of the policyholder’s share in the fair value returns on the underlying items would be inconsistent with the requirements of IFRS 17.

The deduction of a premium for mortality cover from the underlying items is, in effect, an amount paid out of the policyholder’s share. In other words, the policyholder’s share includes that charge.

However, an entity needs to also consider paragraph B101(c) of IFRS 17 in determining whether the definition of an insurance contract with direct participation features is met. Paragraph B101(c) of IFRS 17 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. For the purposes of this condition an entity considers changes in any amounts to be paid to the policyholder regardless of whether they have been paid from the underlying items or not.

See example 2 in Appendix A to this paper *[added note: which is shown below]*.

Appendix A - Example 2—Application of paragraph B101(b) of IFRS 17 (related to S115)

(a) Without mortality charge

An insurance contract gives the policyholder the returns on underlying items, after paying an annual management fee of 0.75% of the assets. The expected duration of the contract is 10 years and the expected returns on underlying items are 5%. The expected account balance is calculated in the following table:

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Opening balance	15,000	15,632	16,290	16,977	17,692	18,437	19,214	20,023	20,867	21,746	
Returns on underlying items	750	782	815	849	885	922	961	1,001	1,043	1,087	9,094
Annual management fee	(118)	(123)	(128)	(134)	(139)	(145)	(151)	(158)	(164)	(171)	(1,432)
Closing balance	**15,632**	**16,290**	**16,977**	**17,692**	**18,437**	**19,214**	**20,023**	**20,867**	**21,746**	**22,662**	

To apply paragraph B101(b) of IFRS 17, the fair value returns are 9,094, of which the entity expects to pay to the policyholder 7,662 (22,662 − 15,000).

(d) With mortality charge

An insurance contract gives the policyholder the returns on underlying items, after paying an annual management fee of 0.75% of the fair value of the underlying items. The expected duration of the contract is 10 years and the expected returns on underlying items are 5%. An annual charge for mortality cover of 100 reduces the underlying items at the start of each year. The expected account balance is calculated in the following table:

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**
Opening balance	15,000	15,527	16,076	16,648	17,245	17,866	18,514	19,189	19,892	20,625	15,000
Mortality charge	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(1,000)
Returns on underlying items	745	771	799	827	857	888	921	954	990	1,026	8,779
Annual management fee	(118)	(122)	(127)	(131)	(136)	(141)	(146)	(151)	(157)	(162)	(1,390)
Closing balance	**15,527**	**16,076**	**16,648**	**17,245**	**17,866**	**18,514**	**19,189**	**19,892**	**20,625**	**21,389**	**15,527**

To apply paragraph B101(b) of IFRS 17, the fair value returns are 8,779. The entity expects to pay to the policyholder 6,389 (21,389 −15,000), having deducted the mortality charge. Hence, in total, the share of the fair value returns that the entity expects to pay to the policyholder is 7,389 (6,389 + 1,000).

Appendix B - Life Act Extracts

Life Act

Operation of statutory funds

Statutory and benefit funds are a LIA construct. It is noted that the LIA generally applies as if references to a statutory fund were references to an approved benefit fund of a friendly society (Section 16G). The key sections of Part 4 of the LIA are outlined below.

1) Section 30, principal requirements regarding statutory funds; e.g.

> 30 *The principal requirements of this Part in relation to statutory funds may be summarised as follows:*
>
> *(a) all amounts received by a life company in respect of the business of a fund must be credited to the fund;*
>
> *(b) all assets and investments related to the business of a fund must be included in the fund;*
>
> *(c) all liabilities (including policy liabilities) of the company arising out of the conduct of the business of a fund must be treated as liabilities of the fund;*
>
> *(d) the assets of a fund are only available for expenditure related to the conduct of the business of the fund;*
>
> *(e) …;*
>
> *(f) profits and losses of a statutory fund may only be dealt with in accordance with Divisions 5 and 6 (the object of those Divisions being to ensure that such profits and losses are dealt with in a manner that protects the interests of policy owners and is consistent with prudent management of the fund).*

2) Section 31, requirement that company have statutory funds, e.g.

> *31 (a) a life company must at all times have at least one statutory fund in respect of its life insurance business but may have more statutory funds if it chooses to do so;*
>
> *(b) a life company that carries on life insurance business consisting of the provision of investment-linked benefits must maintain a statutory fund or statutory funds exclusively for that business so far as it is carried on in Australia;*

3) Section 32, duty of company in relation to statutory funds;
4) Section 34, assets of statutory fund;
5) Section 36, payments to statutory fund;
6) Section 37, capital payments to statutory funds;
7) Section 38, expenditure and application of statutory fund
8) Section 45, transfer of assets between funds

Allocation of operating profit or loss and capital payments

The key sections are:

1) The meaning of an operating profit and operating loss (subsection 58).

> *58 (1) A category of business of a statutory fund has an operating profit for a period if the income of the category for the period exceeds outgoings of the category for the period. The amount of the operating profit is the amount by which income exceeds outgoings.*
>
> *(2) A category of business of a statutory fund incurs an operating loss for a period if the outgoings of the category for the period exceed the income of the category*

for the period. The amount of the operating loss is the amount by which outgoings exceed income.

1) the requirement to allocate operating profit or loss for the period of a category of business of a statutory fund (subparagraph 57 and 59(1));

   57 If annual financial statements given to APRA under the Financial Sector (Collection of Data) Act 2001 disclose that a category of business of a statutory fund has an operating profit for the period to which the statements relate or has incurred an operating loss for the period, the life company must allocate the profit or loss, as the case may be.

   59 (1) A life company must allocate all of the operating profit or loss of a category of business of a statutory fund for a period.

2) The need for a life company to identify the amount of profit or loss in its financial statements prepared as at the end of the period (subparagraphs 59(2)(a) and 59(3)(a)).
3) The amount of profit to be treated as, and added to shareholders' retained profits (subparagraphs 59(2)(e)).
4) The proportion of the loss to be treated as, and deducted from shareholders' retained profits (subparagraphs 59(3)(e)).
5) <u>the requirement to treat the amount of operating profit as, or added to, PRP and SRPP (subparagraphs 59(2)(b-d));</u>
6) <u>the requirement to portion the amount of loss to be taken into account in reduction of PRP and SRPP (subparagraphs 59(3)(b-d)); and</u>
7) the treatment and allocation of capital payments (subparagraphs 59(4-5)).

Prescribed LIA rules

Items in this section are those that the LIA prescribes to be done in a particular way. The LIA is not complied with if any of these is done in a different way.

The items worth noting are:

1) The rules of allocating operating profit and loss – e.g. the 80/20 rule (Subparagraphs 60(1) and (2)). For ease, Division 5 (allocation of operating profits and losses and capital payments) is included in Appendix A.

   60 (1) The allocation of an operating profit of a category of business of a statutory fund must be made in accordance with the following rules:

   (a) in the case of a profit of a category representing Australian participating business, at least 80%, or such higher percentage as is specified in the constitution of the company, of the profit must be treated as, or added to, Australian policy owners' retained profits of the statutory fund;

   60 (2) The allocation of an operating loss of a category of business of a statutory fund must be made in accordance with the following rules:

   (a) in the case of a loss of a category representing Australian participating business, no more than 80%, or such higher percentage as is specified in the constitution of the company, may be taken into account in reduction of Australian policy owners' retained profits of the statutory fund;

8) The rules of distributing retained profits (Section 62). For ease, Division 6 (distribution of retained profits) is included in Appendix B.
9) The rules of distributing shareholders' capital (Section 63).

Items which APRA has discretion to define

Items in this section are those that the LIA gives APRA the power to define. They are:

1) the definition of Participating and non participating benefits (Section 15);
10) what constitutes income and outgoings of a statutory fund (Section 47);
11) the starting amount (Subsection 61(1));
12) the distribution of Australian policy owners' retained profits (Subsection 62(5)); and
13) the method of valuing policy liabilities (Section 114).

Note that the above list is not exhaustive. For example, it excludes powers relating to benefit funds, restructuring/terminating statutory funds and Part 10A on prudential standards and directions.

Definition of participating and non-participating benefit
Part 2, Section 15 of the LIA defines participating and non-participating benefits. For ease of reference, an extract is included below.

15 (1) Subject to this section, a participating benefit is any benefit other than a non-participating benefit.

(2) Subject to this section, a non-participating benefit is a benefit that has the following features:
(a) the benefit does not include any entitlement to share in any distribution by the life company of profits or surplus;
(b) the amount of the benefit is specified in the policy document or is to be calculated according to a formula that:
(i) is set out in the policy document; and
(ii) does not include any element that is in any way dependent on, or to be ascertained according to, a decision of the life company concerned.

Subparagraphs 3-5 provide rights to APRA to define a benefit as participating or non-participating.

15 (3) A benefit is a non-participating benefit if it is declared by the prudential standards to be a non-participating benefit.

(4) APRA, at the request of a life company, may make a written declaration:
(a) that benefits of a specified kind, when provided for by policies issued by the company, are, or would be, participating benefits; or
(b) that benefits of a specified kind, when provided for by policies issued by the company, are, or would be, non-participating benefits.

(5) If APRA makes a declaration:
(a) this Act has effect accordingly; and
(b) APRA must give a copy of the declaration to the life company at whose request the declaration was made.

For the purposes of subsection 15(3) of the Act, APRA has specified in paragraphs 24 to 29 of LPS 600 the benefits to be classified as non-participating if conditions are met. These include investment-linked contracts and investment account contracts if, amongst other things, the benefit does not include any entitlement to share in any distribution by the life company of profits or surplus.

Ascertainment of income and outgoings of a statutory fund
Section 47 provides powers to APRA to specify what constitutes income and outgoings of a statutory fund.

47 (1) The prudential standards may specify:
(a) what constitutes income of a statutory fund; and

> (b) *what constitutes outgoings of a statutory fund.*
>
> (2) *If prudential standards are made for the purposes of subsection (1), then, for the purposes of this Act:*
>
> (a) *what constitutes income of a statutory fund must be determined in accordance with the prudential standards; and*
>
> (b) *what constitutes outgoings of a statutory fund must be determined in accordance with the prudential standards.*

Starting Amount
Subsection 61(1) refers to the starting amount as that determined by prudential standards:

> *61 (1) ….starting amount, for the purposes of a definition in this section, means the amount ascertained in accordance with prudential standards made for the purposes of the definition.*

For the purpose of subsection 61(1) of the Act, APRA has specified in paragraph 30 of LPS 600 that:

> *30 the starting amount for each of the following amounts in respect of a statutory fund of a life company is the amount the life company used as the starting amount for the purposes of preparing statutory returns submitted to APRA for the financial year of the company ending in the year ending 31 December 2011 under the FSCODA, or zero if the company was not registered under the Act at that date, unless APRA determines otherwise in writing:*
>
> *(a) Australian policy owners' retained profits;*
> *(b) overseas policy owners' retained profits;*
> *(c) shareholders' capital;*
> *(d) shareholders' retained profits (Australian participating); and*
> *(e) shareholders' retained profits (overseas and non-participating).*

Distribution of shareholders' retained profits
Section 62(5) enables prudential standards to prohibit the distribution of shareholders' retained profits (Australian participating). It states:

> *62 (5) The prudential standards may prohibit the distribution of shareholders' retained profits (Australian participating) unless the distribution is in accordance with specified requirements relating to the distribution of Australian policy owners' retained profits.*

For the purposes of subsection 62(5) of the Act, APRA has specified in paragraph 31 of LPS 600 that the distribution of shareholders' retained profits (Australian participating) from a statutory fund is prohibited if:

> *31 (a) there is not, at the same time, a distribution of Australian policy owners' retained profits from the statutory fund; and*
>
> *(b) immediately after the distribution, the shareholders' retained profits (Australian participating) of the statutory fund that remain undistributed are less than 25 per cent (or such lower percentage as is specified in the life company's constitution) of the Australian policy owners' retained profits of the statutory fund that remain undistributed.*

Appendix C – Substantial Proportion Illustrations & Illustrative Calculations

C1 Substantial Proportion (B101(c)) Illustration

The following illustrates the determination of the substantial proportion expectation (B101(c)) for Views One to Three.
In this simple example:

- the death benefit is assumed to be outside the underlying items and no charge is made for provision of death cover;
- profit (investment surplus over deposit) is shared 80:20 and credited fully
- A simple maturity guarantee applies

Caveats:

- The model operates over only a single time period
- There is no allowance for a "smoothing reserve" which could impact on the way policyholder payments respond to changes in the underlying items over time
- There is no allowance for a terminal bonus on claim, surrender or maturity
- With respect to the claim risk, we have modelled a constant sum at risk – this could be modelled in different ways to respond to changes in underlying items, and in practice it may or may not itself be provided for out of the underlying items.
- There is no allowance for the variation in claims risk over time (e.g. increased mortality risk at older ages)
- The modelled guarantee is constant over the projection. In practice, with for example the addition of reversionary bonuses this could increase depending on the performance of the underlying items

Probability	Event	UI Amount		Crediting	Variable Fee
5.00%	*UI with Very High Fair Value Return (VHFVR)*	*10,000*		4,000	1,000
25.00%	*UI with High Fair Value Return (HFVR)*	*7,000*		1,600	400
40.00%	*UI with Medium Fair Value Return (MFVR)*	*5,500*		500	-
25.00%	*UI with Low Fair Value Return (HLVR)*	*4,000*		500	(1,500)
5.00%	*UI with Very Low Fair Value Return (VLFVR)*	*3,000*		500	(2,500)
0.20%	*Death Benefit*	*20,000*			
	Opening Deposit	*5,000*	*Deposit*		
	Minimum Payout (Guarantee)	*5,500*	*Guarantee*		

Scenario	Pay-out	Probability	Change in FCF	Change in UI Fair Value		View One (PH Total)		View Two (PH Change)		View Three (PH v UI)	
						Varies	Fixed	Varies	Fixed	PH Δ	UI Δ
#1	9,000	4.99%	3,022	4,400		3,500	5,500	3,500	500	4,000	5,000
#2	6,600	24.95%	622	1,400		1,100	5,500	1,100	500	1,600	2,000
#3	5,500	39.92%	(478)	(100)		-	5,500	-	500	500	500
#4	5,500	24.95%	(478)	(1,600)		-	5,500	-	500	500	(1,000)
#5	5,500	4.99%	(478)	(2,600)		-	5,500	-	500	500	(2,000)
#6	20,000	0.01%	14,022	4,400			20,000		15,000	15,000	5,000
#7	20,000	0.05%	14,022	1,400			20,000		15,000	15,000	2,000
#8	20,000	0.08%	14,022	(100)			20,000		15,000	15,000	500
#9	20,000	0.05%	14,022	(1,600)			20,000		15,000	15,000	(1,000)
#10	20,000	0.01%	14,022	(2,600)			20,000		15,000	15,000	(2,000)
Expected FCF	**5,978**	100.00%	0		**Expected**	**449**	**5,529**	**449**	**529**		
Expected UI	**5,600**	100.00%		0							
				Proportion That Varies		=	**7.5%**		**45.9%**	Correlation :	**79.0%**

As the staff noted in their comments on the S115 submission, all expected payments are included in the assessment under B101(c).

Assessment is made under the views as follows:

View One:

For each scenario, assess the extent to which the amount paid to the policyholder varies as a result of the change in the underlying items.

The proportion is then the probability-weighted sum of the variable component of amounts paid over the expected total amount paid over all scenarios.

That is: 449 / (449 + 5529) = 758 / 5978 = 7.5%.

View Two:

For each scenario, determine the change in the amount paid resulting from the change in the underlying items.

The proportion is then the probability-weighted sum of the change in policyholder benefit due to change in underlying items in all scenarios over the expected total change in policyholder benefit over all scenarios, given that the policyholder starts with $5,000, and there is a minimum guaranteed payout of $5,500. That is: 449 / (449 + 529) = 449 / 978 = 45.9%.

View Three:

For each scenario:

- assess the change in the amount paid to the policyholder in each scenario relating to a change in the underlying items; and
- assess the change in fair value of the underlying items in each scenario.

The proportion that varies may then be measured as the correlation between the probability weighted changes in amounts paid in all scenarios, including those scenarios where a death benefit is paid, relative to the probability weighted changes in the underlying items.

That is: Correl(probability-weighted D amounts payable to policyholder , probability-weighted D underlying items) = 79.0%[1].

---

[1] Correl() is the correlation function given by:

$$Correl(X,Y) = \frac{\sum (x-\bar{x})(y-\bar{y})}{\sqrt{\sum (x-\bar{x})^2 \sum (y-\bar{y})^2}}$$

, where $\bar{x}$ and $\bar{y}$ are the sample means.

ATT6C

Australian Government
Australian Accounting Standards Board

VFA Eligibility

AASB 17 TRG Meeting
22 March 2021

Presenter
Guy Elliott

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Overview of issues

This note was produced for discussion purposes at the VFA focus group to consider whether Australian participating business can be eligible for the VFA and sets out the focus groups' collective discussion of:

- the eligibility criteria and the issues and challenges arising in determining VFA eligibility;
- application at transition; and
- the potential impact of transfers of insurance contracts and business combinations.

In particular, the team focused on the following key areas:

- a) How do you evaluate an expectation that a substantial share will be paid per B101(b)?
- b) How do you evaluate an expectation that a substantial proportion of changes in amounts payable will vary with change in underlying items per B101(c)?
- c) What are suitable dates for assessing VFA eligibility of acquired business?

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Contentious Issues

Issue	Points of Contention
How do you evaluate an expectation that a substantial share will be paid, per B101(b)?	We see two views regarding whether the assessment of the policyholder share against the fair value return is gross or net of investment taxes / annual management charges: VIEW 1: Fair value returns on underlying items determined before investment taxes, are compared against expected payments to policyholders out of net of tax investment return VIEW 2: The comparison should be done on a consistent basis (i.e. both items are net of investment taxes or both items are gross of such taxes)
How do you evaluate an expectation that a substantial proportion of changes in amounts payable will vary with change in underlying items per B101(c)?	There are at least 3 possible views in assessing B101(c): VIEW 1: Of the total amount expected to be paid to policyholders, a substantial proportion varies in some way with the fair value of the underlying items. VIEW 2: Of any change in the amount expected to be paid to policyholders, a substantial proportion varies with (or is explained by) the change in underlying items. VIEW 3: A substantial proportion of any change in underlying items flows into (is correlated with) the change in amounts paid to policyholders. The correlation is assessed across all scenarios.
What are suitable dates for assessing VFA eligibility of acquired business?	In our view, it appears the intention of AASB 17 is that: • the grouping, recognition and eligibility for measurement under VFA of acquired contracts should be done as at the date of transaction, except that • the nature of the contract is assessed at the date of contract inception, as long as the contract was acquired no later than the transition date.

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