

Investment return services

We note the staff paper for the January 2019 board meeting on the recognition of the CSM in profit or loss in the general model and the tentative decision to amend the standard as a consequence.

We are supportive of introducing the concept of investment return services to IFRS 17 because this reflects the fact that an insurance contract may provide the policyholder with investment services as well as insurance services. We note that this is particularly helpful where a contract fails to meet the criteria for the variable fee approach but still contains investment services

We would like to take this opportunity to raise two matters of clarification with you:

1. How to interpret paragraph 31(b) (iii) of the staff paper in the context of annuities; and
2. The implications for implementation of introducing new requirements in relation to investment return services.

1. *Interpreting paragraph 31(b)(iii)*

The staff paper recommends that IFRS 17 should be amended to establish that an investment return service can only exist when an insurance contract contains an investment component. If a contract does not contain an investment component it cannot provide an investment return service.

Criteria for determining whether a deferred annuity contains an investment component are included in paragraph 31(b). These are relevant to UK insurers that issue bulk annuity contracts.

Summary of relevant aspects of UK deferred annuities

Under a bulk annuity contract the obligations to pay future pension benefits to members of defined benefit pension schemes are transferred from the pension scheme to the insurer (either via a buy in arrangement where the insurer's obligation is to pay pension trustees who retain liability to scheme members, or via a buy-out arrangement where the insurer's obligation is to the individual members). The liabilities assumed typically include obligations to pay future pension benefits to deferred members after they have reached retirement age.

Once the obligation to pay future pension benefits has been transferred to the insurer, the individual members of the pension scheme (now individual policyholders of the insurer in a buy in scenario) may choose to transfer the obligation to pay their future pension benefits to another insurer. The transfer value would usually be calculated based on the policyholder's accrued pension benefits. If the policyholder dies during the deferral period, depending on the terms of the contract, a payment may be made to nominated beneficiaries. There are several different bases for such payments, including a return of premiums paid by the policyholder, the accrued pension benefits, or a multiple of the annuity amount.

Does a UK deferred annuity have an investment return service?

Paragraph 31(b) states that a deferred annuity with at least one of the following features does not contain an investment component:

- (i) no surrender value in the accumulation phase;
- (ii) no payment on death in the accumulation phase; or
- (iii) no guaranteed payments in the annuity phase.

As described above, many deferred annuities do not have guaranteed payments in the annuity phase and thus our interpretation is that such contracts would not have an investment return service applying the conditions in the staff paper, although they would in many cases have a surrender value (a transfer value) and a payment on death in the accumulation phase. The death payment may in some cases be relatively small, particularly if the policyholder is no longer employed by the sponsoring employer.

Although this would mean that the contract does not provide an investment return service, the policyholder can receive payments during the deferred period, either on death, by transferring the benefits under the contract to another provider, or in certain cases taking a lump sum.

We infer from paragraph 35 of the staff paper that these payments relate to insurance coverage because they do not relate to investment return services. Further, we infer that this would also apply to contracts that have guaranteed amounts payable in the annuity payment period.

It would be helpful to understand if we have understood the implications of this paragraph correctly as we believe it is an important point when considering how such features should be accounted for under IFRS 17. It would also be helpful to know which aspects of the paper may be included in the revised standard.

2. The implications for implementation of introducing new requirements in relation to investment return services

The proposals in the staff paper would introduce a requirement to consider investment return services in the allocation of the CSM. Per paragraph 35 of the staff paper, an entity only considers investment return services where the insurance contract has an investment component. We discuss in this part of the note the following areas:

- Ambiguity and inconsistency in accounting for insurance contracts with multiple services;
- Contracts with similar commercial features that may be subject to different profit and revenue recognition requirements, resulting in inconsistency in financial reporting; and
- An increase in operational complexity.

Ambiguity and inconsistency in accounting for insurance contracts with multiple services

We note that IFRS 17 contains little guidance on identifying and accounting for separate services within insurance contracts. The introduction of investment return services may further complicate an ambiguous topic.

For example, deferred annuities may contain a variety of features relating to transfer values, death-in-service benefits and guaranteed payments. Some of these features are single payments (for example, the amount paid on transfer) and some are regular payments (the annuity payments). It would help to establish guidance on identifying coverage units in contracts that contain both death benefits and regular annuity payments.

The proposals would not provide an objective or criteria for deciding whether to include an investment return service when determining coverage units, nor would there be any guidance on the pattern of delivery of the services other than it being on a systematic and rational basis.

While this will help preparers reduce the complexity of implementation, it may result in inconsistent application, both from:

- judgment being applied differently in deciding whether to include an investment return service when determining coverage units; and
- different assessments about the relative weighting of the benefits provide by insurance coverage and investment return services and their pattern of delivery.

We believe this is a wider issue than investment return services and stems from a lack of clarity and guidance on accounting for separate services in insurance contracts. It may help to establish some principles generally about how to identify and account for multiple services within insurance contracts as part of the changes required to incorporate investment return services.

Inconsistency in profit recognition for arrangements with similar commercial features

Example 1

Consider two contracts that a policyholder could enter into that would achieve the same economic effect as an immediate annuity with a guaranteed period:

- a non-guaranteed annuity; and
- a reducing term assurance.

Together, these could be designed to pay out identical cash flows with identical risks to a guaranteed annuity. However, profit and revenue recognition may be different to an immediate annuity with a guaranteed period because the separate contracts have no investment components and hence no investment return services. In this example, we think that an appropriate release of the CSM could be achieved without considering the investment component.

Example 2

Consider two examples of deferred annuity contracts:

The first contract has the following features:

- The ability for the policyholder to transfer their benefits at any time during the deferred phase from the current insurer to another provider (a transfer value);
- A death benefit payable to the policyholder's spouse during the deferred phase. This benefit may be a lower amount than the transfer value;
- An annuity payable until death from the date of retirement.

Per the criteria in paragraph 31 (b) of the staff paper, this contract does not contain an investment component because there are no guaranteed payments in the annuity phase. Thus, the coverage units would be assessed based only on the insurance coverage provided under the contract.

The second contract is identical to the first, except that it pays the sum of five years' annuity payments if the policyholder dies during the first five years of the annuity being paid. In this case, the entity would need to identify an investment component (being the lower of the amount payable in the deferred period and the guaranteed amount payable in the annuity payment phase) and allocate its compensation for providing the guarantee separately from other services. In many contracts, the expected value of the cash flows under the guaranteed components are relatively

small, although in some cases the guaranteed periods can extend to many years, in which case the expected value could be more significant.

Operational complexity

We note that the staff's intention is to avoid being prescriptive on accounting for investment return services and for preparers to use judgment in applying the requirements.

However, we feel there is a risk that the addition of new requirements at this stage of the implementation of IFRS 17 may require insurers to revisit analysis and decisions made to date in relation to revenue recognition, which could be time-consuming and may incur additional costs. We note that the principle objective in IFRS 17 for identifying investment components was to ensure that revenue and service expense was not overstated. Linking the existence of investment return services to whether the contract has an investment component may result in practical difficulties.

Thus, we feel that the wording of the change will be important to avoid additional complexity, even though this may result in further implementation questions for the TRG.