IFRS Today

KPMG's podcast series on IFRS and financial reporting

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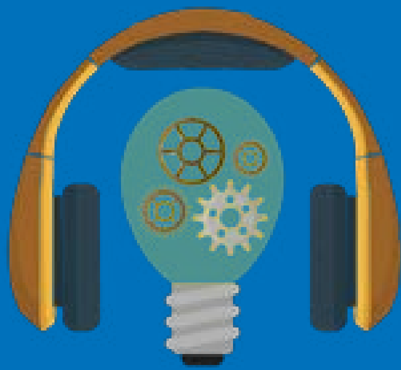

EPISODE 3 TRANSCRIPT

Insurance contracts – CSM allocation: What's the issue?

Speakers

- Mary H Trussell
- Joachim Kölschbach
- Bryce Ehrhardt
- James Bowe (Host)

Mary H Trussell
Global Insurance Change Lead Partner
KPMG AG
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Host

Hello and welcome to episode 3 of *IFRS Today*, KPMG's podcast series on IFRS and financial reporting.

Today I'm pleased to have with me three KPMG colleagues, all well experienced in helping clients make the transition to the new accounting standards. First, we have Mary Trussell – Mary is KPMG's global lead partner for insurance change. She's joined by Joachim Kölschbach, KPMG's global IFRS insurance leader. Finally, Bryce Ehrhardt – an insurance specialist in our very own International Standards Group.

So, Mary, Joachim and Bryce – Thanks for joining us on *IFRS Today*.

Joachim Kölschbach
Partner
KPMG AG
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Bryce

Thanks James, happy to be here…

So what we thought we'd talk about in this episode is essentially how to release the CSM to profit or loss. The CSM is short for Contractual Service Margin and that is what IFRS 17 essentially defines the unearned profit in an insurance contract as.

This unearned profit is recognised in the liability of remaining coverage at initial recognition and, as services are provided, it is recognised or moved to the statement of profit or loss

So Mary, why is this such a big deal?

Bryce Ehrhardt
Senior Manager
International Standards Group

Mary

As you would expect, I’m seeing how to release the CSM creating a lot of noise (implementation questions) in the insurance market right now as insurers work out what IFRS 17 means for their business. That’s because the CSM drives their bottom line, and so any questions circulating about these areas makes it really hard for insurers to predict the impact of the new standard on their earnings.

Joachim

We can break down the discussion into three sets of contracts:

– The first – contracts *without* investment-related services;

– The second – contracts *with* investment-related services that **are** direct participating contracts services

– and third – contracts *with* investment-related services that are **not** direct participating contracts

Bryce

I think Joachim, you and Mary would both agree with me that over the past few months there has been a bit more clarity that has been provided over those first two of these sets of contracts. That clarity has been provided in different discussion forums. In particular, the transition resource group for IFRS 17, and even in the June Board meeting where this was discussed as well and we’ll get into a bit later. But for the time being let’s give it a go and start with a brief discussion about contracts *without* investment-related services.

Mary

So the question that arises for these contracts is what factors should be considered in determining the quantity of benefits provided in order to provide an appropriate pattern of CSM recognition. And what we have learned from the past two TRG meetings is that the quantity of benefits provided should be determined from the policyholder’s perspective. So that means the benefits that they are going to receive if a loss event occurs.

Now, that on its own isn’t necessarily enough to help an insurer determine a method for estimating the services provided for all the different kinds of contracts that it offers.

Bryce

Agreed Mary. And what that means to me is that for a plain vanilla group of contracts – something with similar risks and levels of cover, essentially a straight line method of releasing your unearned profit – would suffice. However, you would need to remember that the CSM is the unearned profit for a group of contacts, so of course you still need to consider the number of contracts in the group and as they lapse off, those would have to be reflected as well within your release pattern.

Joachim

Yes, but, for some contracts a different method may be needed… For example, some contracts provide a high level of cover at the early years on the insurance and less towards the end, like mortgage cover with declining principle. For such contracts, it is sensible to recognise more profit in the earlier years.

Mary

And for contracts like these, it's really important to find a practical and systematic approach to determine the pattern of CSM allocation in order to, I would say, ease the operational challenges for these new requirements.

But, as Bryce said, a straight line method is very likely to work for simpler – or what we might call plain vanilla – contracts, to help to alleviate some of these challenges and that should be much easier to implement. But we do need to take into account the complexity of contracts where the services provided vary over the contracts' duration.

Bryce

Ok, so let's move on to contracts *with* investment-related services.

If we think back to what we were discussing earlier about unearned profit and releasing the profit as the services are provided – what happens if you have an insurance contract that has more than one type of service? There are insurance contracts out there that provide an insurance service and an investment service. So as we develop the unearned profit in a contract, the question becomes whether or not this release pattern, that is used, can take into account the insurance services only or the insurance *and* investment services.

And this becomes very relevant for insurance contracts that have more than one service. An example of that would be one where you have a contract that's issued and it has two years' insurance services provided. However, it also provides an investment-related service that extends beyond those two years, for example, maybe 10 years.

Joachim

IFRS 17 assumes, explicitly for direct participating contracts, that significant investment-related services are included in the contract. An entity promises an investment return based on the underlying items.

Bryce

So, if we think about these types of contracts, it makes sense that the release pattern would reflect insurance and investment-related services for the CSM.

And what we heard at the June IASB Board Meeting was that the Board tentatively decided that the standard, IFRS 17, should be amended to make this clear.

So now, what about that third set of contracts – those that are *not* direct participating contracts, but have some form of investment-related services?

Mary

So IFRS 17, for that third group, draws what could be seen as a cliff-edge effect between the direct participating contracts that we were talking about and these contracts that don't have direct participation features but do provide investment services as well as insurance services.

At the last TRG meeting, we had a really lively debate and most members noted that these contracts can still provide investment-related services and it would make much more sense from their perspective if investment returns were included in determining the coverage period.

I would expect that at a future IASB Board meeting, the Board is going to consider if any further action is needed regarding the definition of the coverage period for these contracts – contracts that have got investment-related services that are not direct participating contracts.

Joachim

Well, I think the Board's outcome does seem sensible for direct participating contracts as it is consistent with how IFRS 17 identifies and accounts for these contracts.

But a problem pops up if investment-related services are not reflected in CSM allocation for any other insurance contracts.

This could result in economically similar contracts having significantly different recognition patterns. This is because insurance contracts that are not direct participating contracts can still be seen as providing a significant amount of investment-related services.

Bryce, how do you think insurers should be digesting this information?

Bryce

Well Joachim, based on my discussions, it's clear to me that this topic has raised significant uncertainty for life insurers and their advisers. In particular because we are in an implementation period for IFRS 17 and entities are trying to carry on designing and building their CSM engines. Those engines are intended to record, store and release the CSM. And, to be frank, insurers can't necessarily begin preparing their investors for what their bottom line's going to look like when they don't know it themselves.

Mary

I absolutely agree with you Bryce. So they are in a real bind where they can't explain what their future results are going to look like. But even so, there are still practical steps that insurers can be taking now in order to be able to move forward. They know what's in the initial CSM; they know how to update the CSM and – based on that – they can actually move forward with specifying the systems that they are going to need to be able to record, store and release the CSM.

What they don't know is the precise drivers they're going to be using to release the CSM for particular products. They know they're going to need to define parameters to reflect this, but they don't yet precisely know what those parameters are going to be.

And, thinking about it in that way, thinking about – how does the model work and what can I deal with by specifying a parameter? – should help them move forward with their systems design, leaving those parameters to be specified in future once the systems have been designed and tested.

Bryce

Thanks Mary. So this is a very lively topic within the IFRS 17 world and, believe it or not, there is a variety of other topics that we would consider are very lively as well. Regardless, we are still getting a lot of good conversation and intriguing material on all these different topics and that type of information is very useful from an operational standpoint and also within progressing with implementation plans.

Host

Thank you Bryce and Mary and Joachim. Some really good discussion there.

If you're looking for more insight on this and other hot insurance topics, check out our online newsletter at kpmg.com/IFRS 17 or follow KPMG IFRS on LinkedIn.

Thank you all very much for taking the time to listen to our podcast. Look out for our next podcast, which will be released in the coming weeks.