Eligibility for the Variable Fee Approach

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Frequently asked questions on IFRS 17

At a glance

IFRS 17, 'Insurance Contracts', specifies that some participating contracts should be accounted for using the variable fee approach ('VFA'), to reflect that those contracts provide investment-related services which are integrated with insurance coverage, and that the entity receives a variable fee for those services. Given the difference in accounting between the VFA and the general model applied to other contracts, the determination of eligibility for the VFA will have a significant effect on system requirements and reported results. There are a number of key interpretative questions and significant judgements in determining eligibility. This publication summarises the criteria for testing the eligibility for the VFA and the accounting for contracts applying the VFA, along with frequently asked questions ('FAQs').

1. Introduction

Participating contracts are insurance contracts or investment contracts with discretionary participation features where an insurer shares the performance of underlying items with policyholders. IFRS 17 has a specific accounting approach for some participating contracts, defined as 'insurance contracts with direct participation features'. That approach is referred to as the variable fee approach ('VFA'). The VFA modifies the accounting model in IFRS 17 (referred to as the general model) to reflect that those contracts provide investment-related services which are integrated with insurance coverage, and that the entity receives a variable fee for those services.

Given the difference in accounting between the VFA and the general model, the classification of a contract as a contract with or without direct participation features will have a significant effect on system requirements and reported results. In addition, the eligibility criteria are complex, and the entity will need to apply and disclose significant judgements in determining eligibility. In assessing eligibility for the VFA, there are a number of key interpretative questions. This publication summarises the criteria for testing the eligibility for the VFA and the accounting for contracts applying the VFA, along with FAQs.

This publication was originally released in April 2020 and has been updated in September 2021 to amend FAQs 2.1.2, 2.3.1.1 and 2.3.1.2 and to add Example 1 in section 2.1.

1.1 Eligibility for the VFA

IFRS 17 requires an entity to apply the VFA to insurance contracts with direct participation features. Paragraph B101 of IFRS 17 defines insurance contracts with direct participation features as follows:

"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)."

The assessment of eligibility for the VFA is performed at inception of the contracts, and it considers the contractual terms specifying the nature of the participation in underlying items, both the identification of the underlying items and the expected future cash flows for the group of contracts. In practice, an assessment at inception of a contract means that the entity assesses eligibility for the VFA for groups of insurance contracts based on the fulfilment cash flows, which incorporate all reasonable and supportable information available without due cost or effort. IFRS 17 allows an entity to estimate the fulfilment cash flows at whatever level of aggregation is most appropriate from a practical perspective.

The features of participating contracts differ significantly between regions and insurers. Some types of participating contracts, such as unit-linked contracts, continental European 90/10 contracts and UK with-profit contracts, would typically be expected to meet the definition of an insurance contract with direct participation features, and so qualify for the VFA. Similarly, some contracts would typically not be expected to meet the definition of an insurance contract with direct participation features and would not qualify for the VFA. Those contracts (including term life and whole life insurance, protection business, annuity contracts, US-style universal life) would be measured applying the general model.

Because the terms of insurance contracts vary significantly between entities, entities need to analyse whether their insurance contracts are eligible for the VFA, based on the specific fact pattern of their contracts in the economic context in which they are issued.

1.2 Applying the VFA

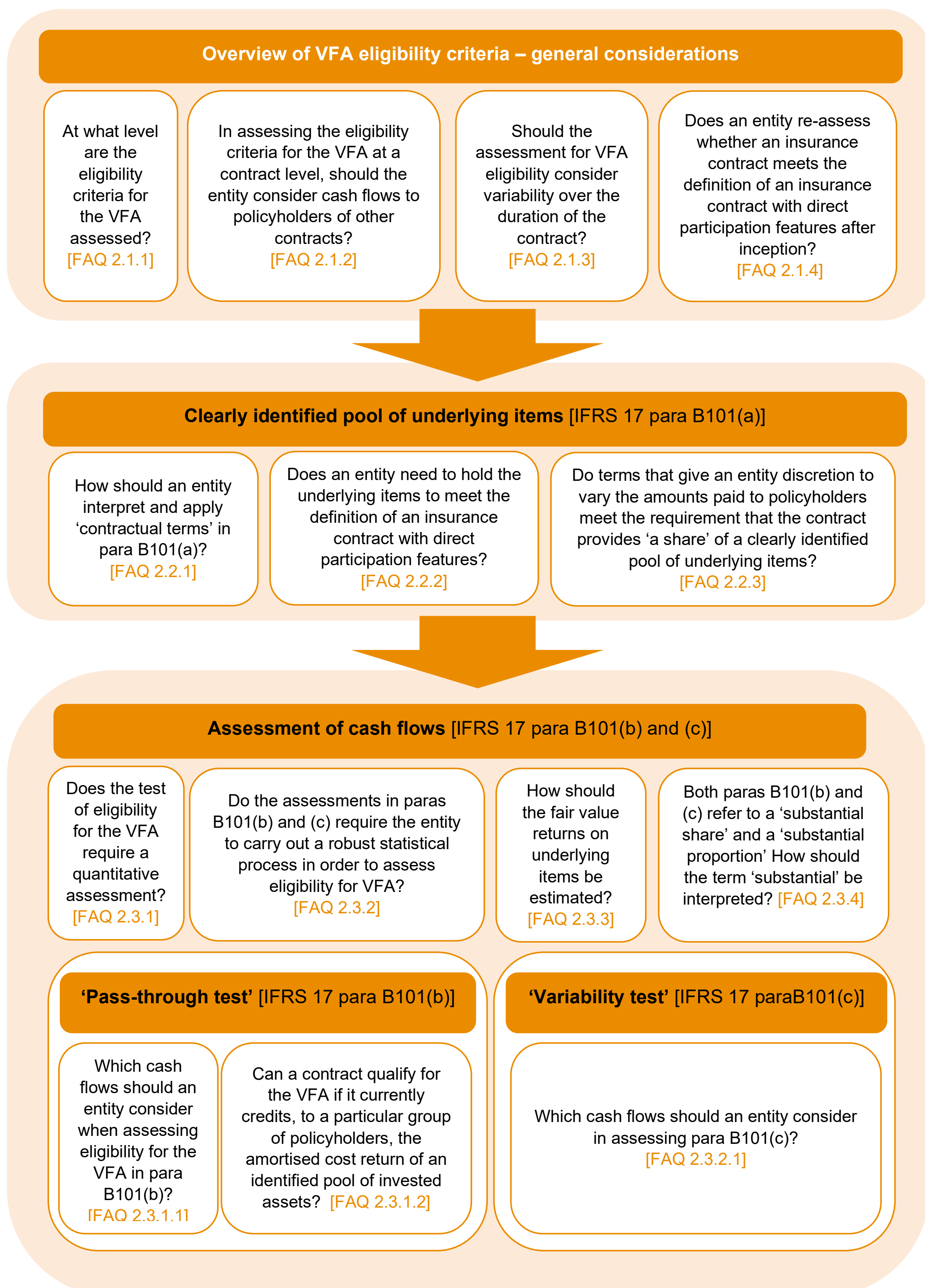
The VFA modifies the general model in IFRS 17 to reflect the IASB's view that, for insurance contracts with direct participation features, the consideration that an entity receives for the contracts is a variable fee for services:

- The services in insurance contracts with direct participation feature are the generation of an investment return for the policyholder (referred to as 'investment-related services'), integrated with insurance coverage.
- The variable fee is based on a share in the underlying items for which the value varies over time and reflects both the investment performance of the underlying items and the other cash flows needed to fulfil the contracts.

The entity earns the variable fee in return for services, which are provided over time. IFRS 17 requires that changes in the fee that relate to future service should also be recognised over the periods in which the entity provides the service promised in the contract, in the same way that changes in the estimates of the costs of providing the contract are recognised. This is achieved by requiring entities to adjust the contractual service margin for changes relating to the fee and future service. Accordingly, IFRS 17 requires, in an insurance contract with direct participation features, the contractual service margin to be adjusted for:

- changes in estimates relating to future underwriting service, similar to other insurance contracts;
- changes in the entity's share of the underlying items; and
- changes in financial risks other than those arising from underlying items – for example, the effect of financial guarantees (except when the risk mitigation option in para B115 applies).

Diagram: In assessing eligibility for the VFA, there are a number of key interpretative questions, illustrated below:



2. Eligibility criteria

2.1 Eligibility criteria – general considerations

Included in the table below are FAQs on determining the unit of account for assessing the criteria:

2.1.1 At what level are the eligibility criteria for the VFA assessed?	Paragraph B107 of IFRS 17 specifies that, when assessing whether a contract meets the definition of an insurance contract with direct participation features, an entity assesses the variability of the amounts to be paid to the policyholder over the duration of the insurance contract. At its meeting in March 2020 (Agenda paper 2C), the IASB noted that the amendment to paragraph B107 of IFRS 17affects the variability test in paragraph B101(c) of IFRS 17, and that it makes a difference to the assessment only when the contract has cash flows for which the assessment of variability changes when assessed for an individual contract rather than for a group of contracts. In practice, insurers are likely to initially assess the eligibility criteria considering the contractual terms of representative policies selected to capture the key features in each product line that determine eligibility. For example, the features could be the nature and extent of financial options and guarantees and fixed insurance features (such as death benefits, and the nature of the sharing mechanism). It might be clear, from that initial assessment, to what extent contracts with similar contractual features and similar risk-sharing mechanisms pass the eligibility criteria. Further investigation, including at a lower level, would be required for contracts where eligibility is not clearly demonstrated in this way.
2.1.2 In assessing the eligibility criteria for the VFA at a contract level, should the entity consider cash flows to policyholders of other contracts?	Yes. Paragraph B102 of IFRS 17 requires an entity to assess whether the conditions in paragraph B101 of IFRS 17 are met using its expectations at inception of the contract. The fulfilment cash flows for a group include all cash flows arising from the contracts in the group. Paragraph B103 of IFRS 17 specifies that to the extent that insurance contracts in a group affect the cash flows to policyholders of contracts in other groups, an entity should assess whether the conditions in paragraph B101 of IFRS 17 are met by considering the cash flows that the entity expects to pay to the policyholders, applying paragraphs B68–B70 of IFRS 17. Because IFRS 17 does not specify which policyholders are referred to in paragraph B103, we believe that there are two acceptable views. An entity should apply either view consistently to all contracts that it issues. View 1: The cash flows that the entity expects to pay to the policyholders refer only to the current policyholders of the contracts in the group. View 2: The cash flows that the entity expects to pay to the policyholders include all of the cash flows described in paragraph B68 of IFRS 17. Paragraph B68 of IFRS 17 states that the fulfilment cash flows for a group 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. Because the eligibility for the VFA is assessed at a contract level, the

	cash flows included in that assessment reflect the level at which the cash flows are specified in the terms of the contract. Those cash flows reflect the level at which the contract specifies that returns on underlying items are shared, including when the contract specifies that cash flows are shared with current or future policyholders of other contracts, both in the group and in other groups. In considering the contractual terms, the entity should consider all of the terms of the contract, explicit or implied, including those imposed by law or regulation.
2.1.3 Should the assessment of the eligibility for the VFA consider variability over the duration of the contract?	Yes. Although eligibility for the VFA is assessed at inception, the assessment should consider the variability expected over the duration of contract – paragraph B107(b)(i) of IFRS 17 requires the variability in the amounts in paragraph B101(b) and (c) of IFRS 17 to be assessed ‘over the duration of the group of insurance contracts’.
2.1.4 Does an entity re-assess whether an insurance contract meets the definition of an insurance contract with direct participation features after inception?	No. The assessment of whether an insurance contract meets the definition of an insurance contract with direct participation features is performed at inception and is not to be reconsidered subsequently. Where paragraphs C9 and C21 apply on transition to IFRS 17, the assessment of a direct participation feature is performed at the date of transition rather than inception.

The following simple example illustrates the assessment of the criteria in paragraphs B101(b) and (c) of IFRS 17 for contracts where insurance contracts in a group affect the cash flows to policyholders of contracts in other groups, as explained in paragraphs B67–B71 of IFRS 17:

Example 1:

An entity has two groups of insurance contracts (Group A and Group B) where the policyholders share returns on the same specified pool of underlying items, and Group A’s policyholders could be required to bear a reduction in their share of the return on the underlying items because of guaranteed payments to Group B’s policyholders.

In this example, the entity expects that the future payments to policyholders of Group A will be reduced, from a share in the returns on underlying items of CU350 to CU250, in order for the entity to make payments of a guaranteed amount to policyholders in Group B.

Paragraph B101(b) of IFRS 17 requires an assessment based on an amount that “*the entity expects to pay to the policyholder*”, and paragraph B101(c) requires an assessment based on the “*amounts to be paid to the policyholder*”. Because IFRS 17 does not specify which policyholders are referred to in paragraph B103, there are two views (as described below) of the cash flows that should be considered in those assessments. An entity should apply either view consistently to all contracts that it issues. In many cases, the determination of the cash flows that are considered in this assessment would be a judgement that has a significant effect on the amounts recognised in the financial statements, and it would be disclosed applying paragraph 122 of IAS 1.

View 1:

The amounts that “*the entity expects to pay to the policyholder*” refer to the amounts determined after considering the fact that the amount that the entity expects to pay the policyholder could be more or less as a result of sharing returns with other (groups of) contracts.

The entity should include only those amounts that the entity expects to pay to the current policyholders of the contracts in the group. These cash flows are sometimes referred to as ‘post-mutualisation cash flows’. In this example, the entity would include the post-mutualisation cash flows of CU250 when considering the criteria in paragraphs B101(b) and B101(c) of IFRS 17.

View 2:

The amounts that "*the entity expects to pay to the policyholder*" should be based on all of the fulfilment cash flows for the contract, which include all of the cash flows attributable to the contract, including those which

might (because of the contractual requirement in the contract to share returns with other policyholders) be paid to other policyholders, including future policyholders.

The entity should include all of the cash flows that the entity expects to pay to all policyholders, both those in the group and those in the other groups that the cash flows are shared with, and both to current and future policyholders.

These cash flows are sometimes referred to as 'pre-mutualisation cash flows'. In this example, the entity would include the pre-mutualisation cash flows of CU350 when considering the criteria in paragraphs B101(b) and B101(c) of IFRS 17.

2.2 Clearly identified pool of underlying items

Under paragraph B101(a) of IFRS 17, for insurance contracts with direct participation features, the contractual terms must specify that the policyholder participates in a share of a clearly identified pool of underlying items. The pool of underlying items 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. Accordingly, insurance contracts with direct participation features include contracts that specify participation in non-financial variables, such as a mortality or expense result.

The IASB explains that the requirement in paragraph B101(a) is needed because, to be considered substantially an investment management contract, paragraph B107(a) requires the contract to specify a fee that is determined by reference to the underlying items (that is, the fee is determinable). For this to be the case, the contract needs to specify that the policyholder participates in a share of a clearly identified pool of underlying items. Paragraph BC245 of the Basis for Conclusions notes that "*Without a determinable fee, which can be expressed as a percentage of portfolio returns or portfolio asset values rather than only as a monetary amount, the share of returns on the underlying items the entity retains would be entirely at the discretion of the entity, and this would not be consistent with that amount being equivalent to a fee.*"

Included in the table below are FAQs on assessing a clearly identified pool of underlying items:

2.2.1 How should an entity interpret and apply 'contractual terms' in paragraph B101(a)?	'Contractual terms' in paragraph B101(a) include all substantive rights and obligations that are enforceable by contract, law or regulation. Contracts with similar terms might be treated differently in different jurisdictions because of different regulation and legal practice. As discussed in paragraph BC69 of the Basis for Conclusions on IFRS 17, the standard explains that contracts can be written, oral or implied by an entity's business practices. An entity is also required to consider all substantive rights and obligations, whether they arise from contract, law or regulation (see para 2 of IFRS 17). Thus, when referring to contractual terms, the effects of law and regulation (including the effects of such laws and regulation on contracts implied by an entity's customary business practices) are also considered. In many cases, there might be no established legal practice or principles related to an entity's obligations. In such situations, the entity might need to exercise significant judgement to conclude whether an insurance contract has direct participation features.
2.2.2 Does an entity need to hold the underlying items to meet the definition of an insurance contract with direct participation features?	No, paragraph B101(a) does not require an entity to hold the underlying items, provided that the items are clearly defined in the contract.

2.2.3 Do terms (either implicit in regulation or explicit in the contract) that give an entity discretion to vary the amounts paid to policyholders meet the requirement that the contract provides 'a share' of a clearly identified pool of underlying items in assessing eligibility for the VFA?	Yes, paragraph B105 of IFRS 17 states that a share does not preclude the existence of the entity's discretion to vary the amounts paid to the policyholder, and it notes that the link to the underlying items must be enforceable (see paragraph 2 of IFRS 17). Accordingly, the policyholder participates in a share of a clearly identified pool of underlying items, typically, under the following terms: ● The entity has discretion over the amount of gains that it shares with the policyholder, but it does not share any losses with the policyholder. ● The entity has discretion over the amount of gains that it shares with the policyholder, subject to a limitation in the amount of losses that it can share with policyholders (for example, to ensure that the policyholder receives at least a return of premium). ● The share is, or the underlying items are, defined in regulation rather than directly in the contract. The underlying items are not clearly defined in the contract where: ● the entity can change the underlying items retrospectively; or ● there are no underlying items identified.

2.3 Assessment of cash flows

Paragraph B101(b) and (c) set out further criteria for the assessment of the VFA eligibility. These tests are designed to identify when the insurer's primary obligation is to pay to the policyholder an amount equal to the fair value of the underlying items, consistent with the view that a contract with direct participation features is similar to an investment management contract. The contract would not be similar to an investment management contract if either of the following applies:

- the entity does not expect to pay to the policyholder a substantial share of the fair value returns on the underlying items; this is because, in an investment management contract, the entity would be expected to pay to the customer most of the returns on the investments; or
- changes in the amounts that the policyholder is expected to receive do not substantially vary with the change in fair value of the underlying items; this is because, in an investment management contract, most of the variability in the amount that the customer receives is expected to arise from variability in the returns on the investments.

Therefore, the eligibility criteria require the entity to examine both the amounts that the entity expects to pay to the policyholder and the amounts that the entity expects to arise from the returns on the underlying items. The quantitative tests look at two ratios, which are intended to assess both:

(a) how much of the fair value return that will arise on the underlying items that the entity expects to pass to the policyholder (that is, the pass-through test in para B101(b)); and
(b) how much of the variability in the amounts that the entity expects to pay to the policyholder arises because of the variability in the fair value of the underlying items (that is, the variability test in para B101(c)).

Accordingly, the entity will need to analyse the cash flows that it expects to pay in contracts with direct participation features to determine whether those cash flows vary directly with the expected fair value returns on the underlying items (para BC239). The cash flows would be analysed as:

- Amounts that vary directly with fair value returns on the underlying items, including:
  - amounts payable to the policyholder that vary directly with the fair value returns on the underlying items;
  - amounts charged by the entity that vary directly with the fair value returns on the underlying items (for example, a charge made as a fixed percentage of the fair value returns on the underlying items); and
  - amounts payable to third parties by the entity or policyholder that vary directly with the fair value returns on the underlying items (for example, fees paid to a third-party asset manager determined as a fixed percentage of the fair value returns on the underlying items).

- Amounts that do not vary directly with the fair value returns on the underlying items, including:
  - amounts payable to the policyholder that do not vary directly with the fair value returns on the underlying items (for example, claims or payments under guarantees);
  - amounts charged by the entity that do not vary directly with the fair value returns on the underlying items – for example, some contracts specify mortality or other charges that are determined without reference to the underlying items; and
  - amounts payable to third parties by the entity or policyholder that do not vary directly with the fair value returns on the underlying items (for example, commissions).

Included in the table below are FAQs on assessing quantitative criteria:

2.3.1 Does the test of eligibility for the VFA require a quantitative assessment?	While IFRS 17 does not explicitly state that a quantitative test should be performed, or provide any specifics on the calculations, the requirement in paragraph B107 of IFRS 17 to make the determination 'on a present value probability-weighted basis' indicates an inherent expectation that some quantitative assessment is required.
2.3.2 Do the assessments in paragraphs B101(b) and (c) of IFRS 17 require the entity to carry out a robust statistical process to assess eligibility for VFA?	Yes. Paragraph B107(b) of IFRS 17 refers to the assessment of the variability in the amounts in paragraphs B101(b) and (c) of IFRS 17 being made on a present value probability-weighted average basis, not a best or worst outcome basis, referring to paragraphs B37–B38 of IFRS 17 relating to estimates of cash flows. Thus, there needs to be a comprehensive scenario analysis, and the assessment should not be restricted to just some scenarios. Paragraph B38 of IFRS 17 states that the starting point for an estimate of the cash flows is a range of scenarios that reflects the full range of possible outcomes. Paragraph B39 of IFRS 17 states that, when considering the full range of possible outcomes, the objective is to incorporate all reasonable and supportable information available without undue cost or effort in an unbiased way, rather than to identify every possible scenario. Paragraph B39 of IFRS 17 also notes that if an entity estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will be sufficient to estimate the smaller number of parameters. However, in some cases, the cash flows might be driven by complex underlying factors and might respond in a non-linear fashion to changes in economic conditions. In such cases, more sophisticated stochastic modelling is likely to be necessary.
2.3.3 How should the fair value returns on underlying items be estimated? The assessments of paragraph B101(b) and (c) require assumptions for returns on underlying items over the life of the contract, which become particularly important for products that include guaranteed maturity values or protection benefits in addition to policyholder account values. Can the assumptions reflect an entity's	The use of the word 'expects' when describing the assessments in paragraphs B101(b) and (c) of IFRS 17 indicates that an assessment over the life of the contract should be performed, which reflects expectations of future returns, and the variability of returns on underlying items, based on available market evidence, if any. Paragraph B44 of IFRS 17 requires estimates of market variables to be consistent with observable market prices at the measurement date. Paragraph 51 of IFRS 17 states that estimated probabilities for non-market variables should not contradict observable market variables. This means that, where an entity's own view of long-term expected returns is used, it is still necessary to

own view of long-term expected returns and the variability of those returns?	ensure that market evidence is taken into account in determining both the expected returns and the variability of returns.
2.3.4 Both paragraphs B101(b) and (c) of IFRS 17 refer to a 'substantial share' and a 'substantial proportion'. How should the term 'substantial' be interpreted?	The interpretation of the terms 'substantial share' (used in paragraph B101(b) of IFRS 17) and 'substantial proportion' (used in paragraph B101(c) of IFRS 17) are matters of judgement. While IFRS 17 provides no guidance on the definition of 'substantial', the terms should be read in the context of the objective, which is to identify contracts that are substantially investment-related service contracts (see paras B101 and B107(a) of IFRS 17).

2.3.1 Substantial share of return on underlying items (para B101(b))

The purpose of paragraph B101(b) is to test the 'pass-through' nature of the insurance contract relative to the returns on the underlying items. The test is therefore performed including only the cash flow returns on the underlying items, and it assesses the proportion of those cash flows that are paid to the policyholder.

Included in the table below are FAQs on assessing share of return on underlying items:

2.3.1.1 Which cash flows should an entity consider when assessing eligibility for the VFA in paragraph B101(b) of IFRS 17?	The criterion in paragraph B101(b) of IFRS 17 is intended to assess the extent to which the policyholder shares in the total returns on the underlying items. To assess this criterion, the entity will need to assess the ratio of the returns that the entity expects to pay to the policyholder to the total fair value returns on the underlying items. The policyholder share of the fair value returns on the underlying items is determined as the gross share, before any deductions for charges paid by the policyholder from its share (for example, for protection benefits). Such charges might be fixed, or they might vary with the underlying items. IFRS 17 does not include requirements or guidance for determining when charges should be considered to be paid by the policyholder from its share. Entities need to apply judgement when establishing a principle for determining which amounts to include in the policyholder's share. For example, an insurer might determine that charges should be added back when they relate to benefits provided that arise other than from the underlying items, or alternatively where the charges relate to insurance rather than investment-related services. In addition, the policyholder's share of the fair value returns on the underlying items is not affected by amounts paid to third parties, if those amounts do not vary with the underlying items.

2.3.1.2 Can a contract qualify for the VFA if it currently credits, to a particular group of policyholders, the amortised cost return of an identified pool of invested assets and, over time, it will ultimately pay a substantial share of the fair value returns on those underlying items to current or future policyholders in the same or other groups?	Yes, a contract that provides a return to current policyholders based on amortised cost can qualify for the variable fee approach, provided that the entity expects to pay a substantial share of the fair value return to the group of policyholders over the life of the underlying items. Applying View 1 of FAQ 2.1.2, the group of policyholders would comprise only the current group of policyholders over the life of the underlying items. Applying View 2 of FAQ 2.1.2, the group of policyholders would comprise the current group of policyholders and policyholders in other groups (including future policyholders) over the life of the underlying items. In February 2018, the TRG noted in responding to submission S26: "*Contracts that provide a return that is based on an amortised cost measurement of the underlying items would not automatically fail the definition of insurance contract with direct participation features. Applying paragraph B107 of IFRS 17, entities expectations would be assessed over the duration of the contracts, and therefore returns based on amortised cost measurement might equal returns based on fair value of the underlying items over that duration*".

The following simple example illustrates how the entity analyses different types of cash flows and assesses the criterion in paragraph B101(b).

Example 2:

Consider a contract with a premium of CU1,000 that is invested by the entity on behalf of a policyholder in underlying items. The expected fair value (FV) return on the invested premium is CU100. Assume that the entity (E):

- pays to the policyholder 80% of the FV return and retains 20% of the FV return, from which it pays a third-party asset manager 5%;
- expects to pay claims of CU10 and fixed expenses of CU4 to a third party, and the policyholder does not share in the expense and mortality result; and
- receives a fixed protection charge of CU13 from the policyholder.

The cash flows that arise from, and hence vary with, the FV returns on the underlying items are as follows:

- The FV returns on the underlying items = CU100. Of these:
  - the entity expects to pay 80% of the FV returns to the policyholder = CU80
  - the entity expects to receive 20% of the FV returns, of which it pays 5% to a third party; thus
    - the entity expects to receive 20 - 5 = CU15
    - the entity expects to pay to third party = CU5

In summary:

- E receives 20 - 5 - 10 - 4 + 13 = CU14 (this is the entity's fee)
- Policyholder receives 80 + 10 - 13 = CU77
- Third parties receive 5 + 4 = CU9

Therefore, in measuring the contract, the entity determines the change in fulfilment cash flows over the period as CU77 + CU9 = CU86, of which:

- 80 + 5 = CU85 vary with underlying items; and
- 10 - 13 + 4 = CU1 do not vary with underlying items.

In the example above, the amount that the entity expects to pay to the policyholder is 80% of the FV returns on underlying items – that is, CU80[1]. The expected claims of CU10 and the protection charge of CU13 charged to the policyholder do not affect that share. Thus, paragraph B101(b) requires the entity to assess whether CU80 is equal to a substantial share of the CU100.

2.3.2 Substantial proportion of any change in the amounts paid to the policyholder to vary with the change in the fair value of underlying items (para B101(c))

The purpose of paragraph B101(c) is to test how much of the variability in the amounts that the entity expects to pay to the policyholder arises because of variability in the fair value of the underlying items. In other words, it tests the correlation between the variability of policyholder cash flows and the variability in underlying items.

In February 2020, the IASB confirmed the editorial correction that would specify that, when assessing whether a contract meets the criteria for the scope of the VFA, an entity should assess the variability of the amounts to be paid to the policyholder over the duration of the insurance contract (rather than over the duration of the group of insurance contracts). This correction affects the criterion in paragraph B101(c) because the variability of cash flows of a group of contracts would be dampened compared to the variability of the cash flows of a single contract.

Included below is a FAQ on assessing the proportion of amounts paid to the policyholder that vary with changes in fair value of underlying items:

<table>
<tr>
<td>2.3.2.1 Which cash flows should an entity consider in assessing paragraph B101(c) of IFRS 17?</td>
<td>This criterion is intended to assess the extent to which the variability of the payments that the entity expects to pay to the policyholder arises because of variability in the fair value of underlying items.

The expected policyholder cash flows can be analysed as comprising:

1) cash flows that vary with underlying items; and
2) fixed cash flows, and cash flows that vary, but not with underlying items.

To assess this criterion, the entity will need to assess the extent to which changes in the policyholder cash flows (that is, items 1 and 2 listed above) arise because of changes in the fair value returns on underlying items.</td>
</tr>
</table>

The following, highly simplified, example illustrates the principles that the assessment of paragraph B101(c) needs to consider:

- *the extent to which the cash flows in the contract are expected to vary with the underlying items on a probability-weighted basis; and*
- *the effect of fixed cash flows (for example, from a death benefit or because of the effect of a financial guarantee) on the assessment of paragraph B101(c).*

[1] In practice, there are two ways of looking at the policyholder's share of underlying items:
- the policyholder receives 80% of underlying items (that is, CU80 in the example above); or
- the policyholder receives 85% of underlying items of which it pays 5% to the third party (that is, CU85 - CU5 in the example above).

This difference does not affect the determination of whether a share of the return on underlying items is considered to be substantial.

Example 3:

Consider a contract issued by an entity where the policyholder receives either the fair value (FV) on the underlying items on survival to maturity or a benefit of CU20,000 on death. Assume that:

- There is a 99.8% probability that the policyholder survives to maturity, and a 0.2% probability that the policyholder dies during the contract term.
- Independent of the survival of the policyholder, there is a 50% probability that the underlying items grow to CU10,000 and a 50% probability that the underlying items grow to CU3,000.

For simplicity, discounting has been ignored for the purposes of illustration.

There are four possible scenarios[2]:

Scenario 1: 49.9% probability that the policyholder survives to maturity and the underlying items grow to CU10,000 which the entity pays to the policyholder (that is, policyholder cash flows are varying directly with the FV on the underlying items).

Scenario 2: 49.9% probability that the policyholder survives to maturity and the underlying items grow to CU3,000 which the entity pays to the policyholder (that is, policyholder cash flows are varying directly with the FV on the underlying items).

Scenario 3: 0.1% probability that the policyholder dies during the contract term, the underlying items grow to CU10,000 and the entity pays the death benefit of CU20,000 to the policyholder.

Scenario 4: 0.1% probability that the policyholder dies during the contract term, the underlying items grow to CU3,000 and the entity pays the death benefit of CU20,000 to the policyholder.

The fulfilment cash flows are the probability-weighted value of the four scenarios, that is CU6,527[3].

The probability weighted value of the growth in underlying items is CU6,500[4].

The table below sets out the relationship between the change in fulfilment cash flows and the change in FV on the underlying items for each scenario as well as the likelihood of each scenario occurring:

Scenario	Pay-out (CU)	Probability	Change in fulfilment cash flows[5] (CU)	Change in FV on the underlying items[6] (CU)
1	10,000	49.9%	3,473	3,500
2	3,000	49.9%	-3,527	-3,500
3	20,000	0.1%	13,473	3,500
4	20,000	0.1%	13,473	-3,500

In this example, there is a high correspondence between the change in policyholder benefits (that is, the change in fulfilment cash flows represented in the table above) and the change in FV on the underlying items in the scenarios where the policyholder survives until maturity. There are different ways to combine data on

[2] Given that there are two potential outcomes for the underlying items which are independent of the survival or death of the policyholder, this leads to four possible scenarios for the entity. So, in Scenario 1, the probability of 49.9% = 99.8% x 50%.

[3] CU6,527 = 49.9% x CU10,000 + 49.9% x CU3,000 + 0.1% x CU20,000 + 0.1% x CU20,000.

[4] CU6,500 = 50% x CU10,000 + 50% x CU3,000.

[5] Change in fulfilment cash flows = Payment to policyholder – Expected fulfilment cash flows. So, in Scenario 1 = CU10,000 - CU6,527.

[6] Change in FV of underlying items = FV of underlying – Expected value of underlying. So, in Scenario 1 = CU10,000 – CU6,500.

the variation in policyholder benefits relative to the variation in underlying items. In this example the correlation between the change in policyholder benefits and the change in FV on the underlying items is 98.4%[7]. This can be used to support the view 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, on a probability-weighted basis, taking into account the requirements of paragraph B107.

The example illustrates a contract where there is a low probability of the death benefit being paid, and there is no financial guarantee affecting the amounts paid when the policyholder reaches maturity. This is reflected in the strength of the relationship between the change in policyholder benefits and the change in FV of underlying items on a probability-weighted basis. The strength of the relationship would change, for example:

- *If the probability of death was higher*, the cash flows that vary with changes in the FV of the underlying items would be a smaller contribution on a probability weighted basis. In other words, if the cash flows related to the insured event are the most significant component of the total expected policyholder cash flows and a change in the fair value of underlying items has little effect, then the condition in paragraph B101(c) would not be met.

- *If the contract included a financial guarantee that is close to the money when assessment is made*, the payments to the policyholder on maturity would reflect the guaranteed payment in a large number of scenarios, and the cash flows that vary with changes in the FV of the underlying items would be a smaller contribution. Thus, the presence of significant guarantees can mean that the condition in paragraph B101(c) is not met.

3. Applying the VFA

The VFA requires entities to first assess whether cash flows should be classified as one of the following:

- The obligation to pay the policyholder an amount equal to the fair value on the underlying items (see para B104(a)). Paragraph B111 states that these amounts do not relate to future service, and so do not adjust the contractual service margin.
- The 'entity's share of the fair value of the underlying items' (see para B104(b)(i)). Paragraph B112 states that such amounts relate to future service (because they are part of the fee) and thus adjust the contractual service margin, subject to paragraph 45(b).
- 'Fulfilment cash flows that do not vary based on the returns on underlying items' (see para B104(b)(ii)). Paragraph B113 requires that these amounts are analysed into amounts that arise from the effects of the time value of money and financial risks not arising from the underlying items, both of which are treated as relating to future service, and other changes in fulfilment cash flows. Those relating to future service adjust the contractual service margin.

Together, the entity's share of the fair value of the underlying items and the fulfilment cash flows that do not vary based on the returns on underlying items comprise the change in the entity's fee.

Included in the table below are FAQs on accounting treatment of different types of cash flows:

3.1 Under the VFA, how are changes in cash flows that form part of the entity's share of underlying items accounted for?	Applying paragraph B112 of IFRS 17, the entity's share of the fair value of underlying items (that is, para B104(b)(i) of IFRS 17) relates to future service and adjusts the contractual service margin, applying paragraph 45(b) of IFRS 17. This includes current period variances in the entity's share of underlying items. In Example 1, the amount would be CU20.
3.2 Under the VFA, how are cash flows that do not vary based on the returns on the underlying items accounted for?	Applying paragraph B113(a) of FRS 17, the cash flows that do not vary based on the returns on underlying items (that is, para B104(b(ii) of FRS 17), excluding the change in the effect of the time value of money and financial risks not arising from the underlying items, adjust the contractual service margin or are recognised in

[7] The statistical test adopted should be able to determine the strength of the relationship, taking into account the probability of occurrence of the different events tested and the size of the variation of policyholder benefits and underlying items in each event. In this example, a correlation statistic (that is, covariance divided by the standard deviation of policy benefits and changes in fair value) has been illustrated.

	profit and loss, depending on whether the changes affect future service, consistent with insurance contracts without direct participation features (although using current rather than locked-in discount rates when adjusting the contractual service margin). Applying paragraph B113(b) of FRS 17, changes in the effect of the time value of money and financial risks not arising from the underlying items (for example, the effect of financial guarantees) relate to future service and therefore adjust the contractual service margin, except to the extent that the requirement in paragraph B115 of FRS 17 relating to the risk mitigation option applies.
3.3 How does paragraph B113(b) of IFRS 17 apply to changes in the cost of options and guarantees that vary based on both financial inputs (such as interest rates) and non-financial factors (such as mortality, morbidity and lapse), if those cash flows do not vary based on the return of the underlying items?	The change in the cost of options and guarantees should be analysed into (1) the change in the effect of the time value of money and financial risks not arising from the underlying items, which relate to future service, and (2) other changes (such as non-financial factors), which should be further analysed into those that relate to future service and those that do not. The changes that relate to future service adjust the contractual service margin.
3.4 How does paragraph B113(b) of IFRS 17 apply to changes in investment management costs which do not vary based on the returns on the underlying items (as described in para B104(b)(ii)) of IFRS 17?	The changes in investment management costs should be analysed into (1) the change in the effect of the time value of money and financial risks not arising from the underlying items, which relate to future service, and (2) other changes (such as non-financial factors), which should be further analysed into those that relate to future service and those that do not. The changes that relate to future service adjust the contractual service margin.

Conclusion

We hope that you find this Spotlight useful in addressing some of your questions. PwC clients who have questions about this Spotlight should contact their engagement partner.

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