

Coverage period and services provided in deferred annuities

Background

UK insurers underwrite significant volumes of annuity contracts with fixed benefits. This paper considers deferred annuities acquired under a pension 'buy-in' or 'buy-out' (collectively known as bulk annuity contracts).

Under IFRS 17, these contracts will be measured under the general measurement model (GMM). IFRS 17 requires the contractual service margin (CSM) for contracts measured under the GMM to be recognised over the period during which the entity provides coverage for insured events.

Applying these principles to these contracts might result in 'back-end' revenue recognition because the CSM could only be released during the payment period of a bulk annuity contract.

Agenda paper 2D, prepared by the IASB staff for the IASB's Board meeting in October 2018, acknowledged that some stakeholders are concerned that the application of the current requirements in IFRS 17 could lead to unintended consequences, in particular, for some insurance contracts that do not qualify for the VFA approach but provide investment-related services.

The paper stated that the staff are exploring further analysis which might indicate possible amendments that could be made to IFRS 17 to alleviate these concerns without causing significant loss of useful information relative to that which would be provided by IFRS 17 for users of financial statements, or unduly disrupting implementation processes that are already under way.

Although bulk annuity policies do not have account balances, and so are not the type of contracts mentioned in the staff paper, the application of IFRS 17 to these contracts raises similar concerns for UK insurers. The purpose of this paper is to provide the IASB staff with further information to assist its analysis.

Questions addressed in this paper

- 1) What services are provided during the coverage period?
- 2) What is the coverage period for a deferred annuity?

It does not examine the measurement of the quantity of benefits provided during the deferred period.

Conclusions and recommendations

What services are provided during the coverage period?

Regarding the first question, the paper examines a number of potential services provided during the deferred period. It concludes that there may be services provided, including death in service benefits, but that ***other features are unlikely to qualify as services as anticipated under IFRS 17 without modification to the standard.***

What is the coverage period for a deferred annuity?

Regarding the second question, ***our view is that coverage starts from when the contract incepts on the basis that it is necessary that the policyholder survives the deferred period in order to receive any benefits under the contract.*** The consequence of this is that the CSM would be allocated to both the deferred and in-payment periods. This is consistent with view B in the analysis below.

IFRS 17 requirements

The value of the CSM released to profit or loss to reflect services delivered during the period is determined using coverage units. Paragraph B119(a) of IFRS 17 defines the number of coverage units in a group of contracts as *“the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.”* Coverage units are therefore based on the value of the benefits provided to the policyholder and the duration of the group of contracts.

It is understood that the staff’s view is that, as currently drafted, IFRS 17 requires that for insurance coverage to be provided in a period it must be possible for an insured event to occur.

The coverage period is defined in Appendix A of IFRS 17 as *“the period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.”*

At the IASB’s Board meeting in June 2018, the Board tentatively decided to make a clarification to the definition of the coverage period for insurance contracts with direct participation features. The proposed amendment to the definition of the coverage period would clarify that the coverage period for such contracts includes periods in which the entity provides investment-related services.

In Agenda paper 2B, prepared by the IASB staff for this meeting, the staff stated, in its view, that for contracts measured under the GMM, IFRS 17 is clear that the quantity of benefits includes only insurance coverage and the CSM is recognised only over the period during which the entity provides coverage for insured events. It follows that for insurance coverage to be provided in a period it must be possible for an insured event to occur. However, it is conceivable that insurance services might be provided in a period even if no insured event could occur.

What services are provided during the coverage period?

There have been discussions about what services and benefits are provided to the policyholder during the deferral period. These services might not be insurance services. A summary of these discussions is given below:

Death in service benefits

A policyholder's estate, or beneficiaries, would receive a payment if the policyholder died during the deferral period. Insurance services would be provided to the policyholder during the deferral period to the extent that the death benefit exceeds the transfer value of the contract during this period. In most arrangements, the death benefit would not be significantly higher than the transfer value.

If the amount paid on death during the deferral period exceeds the transfer value of the contract, an additional insurance benefit would be paid.

A guaranteed annuity

When a contract is issued, the policyholder is provided with guaranteed insurance benefits at a fixed price. Over time, the guarantee would become more valuable if (say) the longevity of the policyholder increases more than was assumed at the inception of the contract. It is arguable that the fixed price provides the policyholder with an insurance benefit over the duration of the contract. However, all fixed price contracts contain a similar benefit and IFRS 15 *Revenue from contracts with customers* does not identify a fixed price benefit as a separate service that is provided to a customer over the duration of a contract. Although the term 'insurance benefits' is not defined in IFRS 17, the definition of an insurance contract requires the insurer to compensate the policyholder if an insured event adversely affects the policyholder. One possible implication of this definition is that a price guarantee does not create insurance risk and so is not an insurance benefit.

Investment services

Some believe that investment services are provided under these contracts. The price that the policyholder pays is partly determined by the investment income that the insurer expects to receive from the assets which the premium is used to acquire and therefore affects the size of the CSM.

Others believe that bulk annuity contracts do not provide investment-related services to policyholders. The policyholders receive the same benefits however the entity chooses to invest the assets backing the contracts.

What is the coverage period for a deferred annuity?

The coverage period is defined in Appendix A of IFRS 17 as “the period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract.”

A deferred life-contingent annuity with fixed benefits transfers significant insurance risk from the inception of the contract because the benefits payable are assessed based on the conditions (including the policyholder’s health) when the contract is issued and are not reassessed subsequently. If the policyholder survives the deferral period, life-contingent payments will commence after the end of this period at the guaranteed amounts.

For a life-contingent annuity, the policyholder’s entitlement to the next survival benefit becomes unconditional when the policyholder survives to the next payment date.

View A

Other than to the extent any additional death benefit exceeds the transfer value that would be paid to the policyholder’s estate or beneficiaries, no insurance services are provided during the deferral period.

Supporters of view A argue that because an annuity payment is triggered when the policyholder survives to the next payment date, and no payment would be made if (say) the policyholder died the day before the next payment date that the insured event occurs only on the survival date. Because the quantity of benefits includes only insurance coverage and the CSM is recognised only over the period during which the entity provides coverage for insured events it follows that for insurance coverage to be provided in a period it must be possible for an insured event to occur. This view would appear to be consistent with the view expressed by the IASB staff.

Because the first benefit payment for a deferred annuity would be due after the end of the deferral period no insured event could occur and no insurance coverage is provided during the deferral period.

Supporters of view A would also argue that all fixed price insurance contracts contain a price guarantee and that the provision of the guarantee is not a separate insurance service.

Expenses incurred in fulfilling the contract during the deferral period might, or might not, be incurred in providing insurance services. However, any expenses incurred would not be incurred on an insured event and so consistent with the view that, for insurance coverage to be provided in a period it must be possible for an insured event to occur, any expenses incurred in providing insurance services in a period would not mean that insurance coverage is provided in the deferral period if no insured event could occur.

View B

An alternative view is that insurance coverage is provided over the deferral period because the policyholder must survive the deferral period for any insurance benefit payments to be made. Under this view, the insured event is survival because it is necessary to survive in order to receive benefits under the contract.

Supporters of view B argue that insurance coverage for a life-contingent annuity is provided continuously in each period from the previous payment date to the next payment date because it is necessary for the policyholder to survive for the whole of this period for the policyholder to become

unconditionally entitled to the next benefit payment. Insurance coverage is therefore provided over the duration of the contract, including the deferral period, because the policyholder must survive the deferral period for any insurance benefit payments to be made.

Although this view would not appear to be consistent with the IASB staff's view, supporters of view B contend that this view would provide a more accurate representation of the substance of the insurance coverage and would comply with the definitions and principles in IFRS 17.

Some commentators have suggested that while it is a necessary condition to survive in order to receive a payment, it is not a sufficient condition until payments are received under the annuity. However, the Board noted that an entity provides insurance coverage over the whole of the coverage period and not just when it incurs a claim.

Consequently, supporters of view B would also argue that for a pure endowment contract measured under the general model, coverage is provided over the duration of the contract, although a benefit is payable only if the policyholder survives to a specific date.

While this paper does not discuss the allocation of the CSM during the deferral period, a consequence of defining the coverage period to include the deferred period may be that equal amounts of service is being provided in each period, including both the deferred and in-payment periods.