**Accounting for annuities that have vested from with-profits contracts under IFRS 17**

It has been commonplace in the UK market for with-profits savings contracts to contain a guaranteed annuity option ("GAO") that gives the policyholder the option to take out an annuity at a guaranteed rate.

On retirement, the policyholder has the option to acquire an annuity from any provider but will have a financial incentive to stay with the existing insurer if the guaranteed rate is higher than current market rates.

The insurer will typically effect the option by requiring the annuity company or fund in the group to issue the annuity. The annuity company or fund will charge a market price for the annuity to the with-profits fund, which means that the remaining policyholders receive lower benefits than would otherwise be the case.

There are a number of areas of debate relating to these arrangements that are not covered in this note. These include whether:

- There is a contract boundary on the vesting date arising from the re-pricing of the annuity, the cost of which is borne by the with-profits fund (and hence current and future with-profits policyholders); and
- The contract should be separated into a with-profits component and an annuity component.

The outcome of these discussions would both result in the with-profits phase of the contact being accounted for under the VFA and the annuity phase being accounted for under the general model and, as a result, avoid the additional complexities described in this note.

In the case that neither of the above is appropriate, then the reporting entity will need to determine under which model the contracts should be accounted. In some cases, the VFA criteria will not be met (for example, when there is only a short period to vesting, or has already vested) but in others the criteria for VFA will be met.

IFRS 17 does not permit contracts to switch between accounting models. That is, if the contract is determined to qualify for the VFA on inception (or an transition if classification is determined at that point) then it will be accounted for under the VFA until it is derecognised[1].

As a consequence, some contracts within an annuity fund may be accounted for under the VFA, even though others (for example, immediate and deferred annuities that have not vested from with-profits contracts) will be accounted for under the general model.

**The accounting implications**

This section describes the accounting model for an annuity that has vested from a WP contract. It assumes that the annuity qualifies for the VFA for the reason above. It compares it with the accounting model for an identical annuity under the general model. It is worth noting that during the annuity phase there will be no underlying items.

[1] The response to S98 in agenda paper 02 for the April 2019 TRG clarified that the assessment of whether an insurance contract is accounted for applying the general model or the variable fee approach is made at inception applying the definition of an insurance contract with direct participation features in Appendix A of IFRS 17 to a contract in its entirety.

| | General model | VFA |
|---|---|---|
| Accretion of interest on the CSM | Locked-in rate | Current rate |
| Changes in fulfilment cash flows that do not vary based on returns on underlying items | Locked-in rate (B72(c)) | Current rate (B113(a)) |

Under the VFA model, changes to discount rates are effectively adjusted in CSM. It is common for insurers to match the exposure to discount rates with appropriate assets. In this case, assets and liability values would be well matched, but there would be a further adjustment to the CSM which would affect the profit for that year. This issue is not present where the general model is applied to regular annuity contracts, so presents issues of both accounting volatility and incomparability.

Also, it is relatively common for material changes to be made to longevity assumptions for annuities. For example, the FT reported that UK insurers weakened longevity assumptions by c £1.5 bn in 2018. The effect on CSM of discounting the nominal change at historic rates and current rates would likely be highly material for a number of insurers.

**Operational implications**

There are a number of operational implications that arise.

*Annuities would be divided into two portfolios*

Separate portfolios will be required for annuities under the general model and the VFA. This increases the granularity of data required, increases the number of allocations and increases the assumptions data that must be computed and held.

*Reduces the availability of the full retrospective approach on transition*

A CSM on transition for annuities under the VFA will be needed. A number of insurers are concerned that their systems do not contain the source of their annuity contracts (that is, they are not able to determine whether it vested from a with-profits contract), which will mean that they cannot apply the full retrospective approach to any of their annuity business (since the inception date is unknown).

This may be less of a concern under the modified retrospective approach, as this permits determining whether the contract qualifies for the VFA at transition if the entity is unable to make the assessment from the inception date. However, even in this scenario, applying the MRA will be challenging because information about the source of the contract is not available (that is, whether it vested from a WP contract)

*On transition, some contracts may qualify for the general model and others the VFA*

It a modified retrospective approach is applied and the option to make the model assessment on transition is used, some contracts may meet the VFA criteria (because they have a long period until vesting) and others will not (because they will vest sooner or have already vested). This will mean that some contracts that are currently in the with-profits savings phase will be accounted for under the general model, giving rise to inappropriate adjustments to the CSM and therefore profit recognition.

*For annuities that vested from WP contracts that qualify for the GMM on inception, the GMM would need to be applied to the with-profits phase*

A contract may be classified under the GMM on transition under the MRA because it fails the VFA criteria at the transition date. Calculating a CSM for the contract would need to apply the general model principles to the with-profits phase of the contract.

*Determining coverage units*

The proposed changes to the standard would require coverage units to consider both investment and insurance services. While all of the investment services are provided in the savings phase, some insurance services are also provided during this phase as well as during the annuity phase.