

Locked-In CSM Discount Rates

Purpose

The purpose of this paper is to:

- Set out the ICAEW Insurance Committee's reservations for using locked in discount rates in the Contractual Service Margin ('CSM') used by IFRS 17's general measurement model.
- Explain why we believe this issues requires further consideration over and above the points that made in the December 2018 staff paper
- Outline a rationale for use of unlocked discount rates in the CSM for use in the general measurement model.

Background

We recognise the Board's intention in requiring adjustments to the CSM for changes in estimates of cash flows to be discounted at the rate that applied to the original determination of the CSM. This increases consistency between initial and subsequent estimates.

By contrast, the fulfilment cash flows ('FCFs') are measured at the prevailing current rate and whilst future assumption changes to the FCFs are taken to the CSM, the measurement of the impact of these changes is calculated at the locked-in rate for the best estimate liability ('BEL') and at the current rate for the risk adjustment.

We also note the mismatch that arises for entities that recognise changes in discount rates in profit or loss in a period as a consequence of this method. Paragraph 7 of paper 2B for the December board meeting references that this approach gives rise to a gain or loss. In the UK, we anticipate that most insurers will classify most of their assets as FVTPL and will therefore not use the OCI option available in IFRS 17. Therefore, this difference will be reflected in the P&L

While we understand that this is a consequence of using current rates for cash flows and the original rate for unlocking the CSM, there is an argument that this misrepresents the finance expense in the period. This is because it includes an element that relates to reversing amounts recognised in profit or loss in earlier periods (as noted in paragraph 9(a) of paper 2B).

Whether the amount reported in the performance statements is a gain or a loss depends not on whether there has been an increase or decrease in the liability, but on the differential between the historic discount rate at which the CSM is measured and the current rate at which the FCFs are measured. **Field testing has identified that this difference is very material to reported results.** An example to demonstrate this is included below.

The difference in the current discount rate for the BEL and locked in rate for the CSM will distort the current period result in the P&L and shareholder equity for UK insurers. Whilst this potential issue was identified by early IFRS 17 impact assessments, the recent full EFRAG case studies undertaken by major UK insurers have demonstrated that the likely effect of this is much more significant than first thought.

This issue was described in the EFRAG TEG IFRS 17 Industry issues analysis as follows:

“(a) One respondent estimated the pro-forma P&L impact of an annuitant mortality assumption change for 2017 under IFRS 17 (the actual improvement in life expectancy was less than originally expected). Assuming the use of modified or full retrospective approach and given differences in discount rate, about a quarter of the amount would have been recognised in P&L.

(b) Another respondent estimated that when testing sensitivity of results to changes in longevity (also for annuity products), a significant amount would be recognised in insurance finance expense given the larger impact on the liability compared to the CSM (in a decreasing interest rate environment). This is when not using the OCI option for interest rate changes.”

Comments on December 2018 staff paper

We would welcome the opportunity to explore further the staff paper’s rationale for dismissing the concerns arising from the use of a locked in discount rate. The arguments presented in paper AP2B do not align with our experience in practice. In particular the rationale provided does not acknowledge or explain the following:

- The use of a current rate does not impact the amount or timing of the insurance service result
- The linkage between assets and liabilities, the impact this has on the discount rate and hence the impact on reporting of profit (split between insurance service result and investment result and timing of profit recognition).
- Why a current rate is appropriate for VFA business but not GMM business (especially given the important linkage between assets and liabilities that is also relevant in GMM business
- The rationale supporting the desire for consistency in some areas but not others e.g. with initial estimates for GMM, but not consistency with VFA or the principle that operational changes are spread forward
- the concern around increased complexity when in fact unlocking significantly reduces operational complexity
- the view that presentation in OCI resolves the issues when both P&L and OCI are performance statements

Paragraph 18 describes the example where fulfilment cash flows are in an asset position and the CSM is in a liability position, where movements in yields under the GMM only impact fulfilment cash flows, thereby resulting in artificial volatility in comprehensive income. It should be noted this phenomenon is not unusual and occurs frequently for regular premium protection business. Furthermore, the inconsistent treatment of fulfilment cash flows and CSM when yields move occurs for all business accounted for under the General Measurement Model but is most marked for contract where the fulfilment cash flows are in an asset position.

Paragraph 22(b) argues that this assessment is not consistent with IFRS 17 stating that an insurance contract is a combination of rights and obligations arising from a group of insurance contracts as a single asset or liability. However, if an insurance contract is truly a combination of rights and obligations then it could be argued that the resulting single asset or single liability should be measured using a single discount rate.

Finally, paragraph 22(b) refers to paragraph 22(a) which states that requiring the use of current discount rates for determining adjustments to the CSM would damage the consistency in separating the insurance service result from the financial result. **It is important to understand that remeasuring the CSM using the current rate compared to the locked-in rate would not change the insurance result.** Remeasuring the CSM would only change the timing of the emergence of the financial result over the duration of the contract.

Illustrative Example

The tables below illustrate potential anomalous results that occur when there is a change in both discount rate and longevity. The changes shown below are typical of movements that can be expected each year and so do not represent a particularly unusual 'shock event'.

Current rate 3.5%; locked in rate 5.0%

2. Increase in mortality 5% to 5.5%

	1. Decrease in mortality	2. Increase in mortality
1. Decrease in mortality 5% to 4.5%		
2. Increase in mortality 5% to 5.5%		
Balance sheet	£m	£m
Increase/(decrease) in BEL	66	(59)
increase/(decrease) in CSM	(49)	44
Income statement	£m	£m
change to insurance service result	(3)	2
change to net finance result	(18)	15

Current rate 6.5% locked in rate 5%

	1. Decrease in mortality	2. Increase in mortality
1. Decrease in mortality 5% to 4.5%		
2. Increase in mortality 5% to 5.5%		
Balance sheet	£m	£m
Increase/(decrease) in BEL	38	(35)
increase/decrease in CSM	(49)	44
Income statement	£m	£m
change to insurance service result	(3)	2
change to net finance result	12	(10)

Key points to note in respect of these examples are:

- Since the BEL and CSM are measured at different discount rates, the change in BEL is not offset by the change in the CSM (the difference being the difference in discount rate).
- The difference in discount rates is recognised as finance expense in the income statement in the year of the assumption change;
- This means c 30% of an operating assumption change is recognised as finance income/expense in the year of change, with only c. 70% spread forward via the CSM;
- Whether this is an income or expense depends on the differential in interest rates; and whether interest rates are rising or falling not whether the operating assumption change is a release or strengthening.
- Despite the most significant aspect of the movement in BEL being the longevity movement, this is the one thing that does not feature in the current reported profit for the year.
- Risk adjustment has been excluded from this example as, whilst it is expected to be sensitive to interest rates, it recalibrates the CSM at the current rate.

As a result we believe it would be very difficult to explain such movements to users of the financial statements, and we would be concerned that this causes confusion, undermines the usefulness of the financial statements and is very likely to give rise to increased usage of alternative performance measures rather than their reduced use which is one of the IASB's aims.

Proposed Solution

Unlocking the CSM would result in consistent treatment of all components of the balance sheet and would ensure consistency of approach for insurers adopting the general measurement model, as well as with those adopting the VFA model. Further and perhaps most importantly it would mean the performance statement is not confused with material movements arising only from differences in measurement of components of the liability and mitigate the use of non-GAAP measures to explain material amounts that do not in fact relate to performance in the period. This will avoid the significant challenges in explaining performance to users and the further inconsistency of presentation for insurers where fulfilment cash flows have changed and those where they have not.

Alternative Treatments

1. An alternative solution to this problem would be to allow a limited unlocking of discount rates for the CSM where there have been related changes to fulfilment cashflows. This could be achieved by saying that where an adjustment to the contractual service margin of a group of insurance contracts without direct participation features has been made for changes in fulfilment cash flows that relate to future service, the change should include changes in discount rate applied to the change in fulfilment cash flows. The discount rate would only be unlocked in respect of where those fulfilment cash flows have changed. It should be noted that, in practice, the FCFs would typically change every reporting period (which can be evidenced in the financial statements of UK annuity writers).

2. A further alternative that would eliminate this feature of the accounting would be to recognise the difference in OCI rather than in profit or loss. There would be no change to the measurement of the CSM in the statement of financial position. We appreciate that the total amount of finance expense recognised in profit or loss over the duration of the group would no longer reconcile to the value of discounting in the CSM on inception; however, that amount would continue to be recognised in total comprehensive income. In addition, the amount recognised in profit or loss in a specific period would more fairly represent the insurance finance expense in that period.

A simple example is given below:

Consider a change in estimate of FCFs that has a present value of 10 at the current rate and a present value of 12 at the original rate. IFRS 17 would require the following:

Cr FCFs (balance sheet) 10
Dr CSM (balance sheet) 12
Cr Insurance finance expense (profit or loss) 2

Using the OCI approach described above would result in the following:

Cr FCFs 10
Dr CSM 12
Cr Insurance finance expense (OCI) 2

Note that this approach is only relevant where the reporting entity is recognising changes in discount rates in the income statement; for entities using OCI, no difference arises in profit or loss.

Under this approach, the amount recognised in OCI would not be recycled. We appreciate that amounts in OCI are generally recycled under IFRS, although we note that this is not always the case (for example, in relation to realised gains on equities accounted for at FVOCI).