Treatment for Advance Premium Deposit (APD) & Policy Loan

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This IFRS17 Working Paper aims to facilitate discussion among actuaries and other stakeholders to capture the range of opinions on the application of IFRS17 in the Singapore context and is not meant to serve as mandatory practice notes.

Any interpretation of IFRS17 set out in this Paper represents a plausible treatment given the text of IFRS17. However, it shall neither be construed as the only possible treatment nor the agreed interpretation for Singapore insurers. Users of this Working Paper shall be mindful that differences in the exact fact pattern and operating context facing each insurer may drive different interpretations. Users shall also be mindful that for the same fact pattern and operating context, there is scope for the substance of same transaction to be articulated differently depending on how the transaction is analysed. (For example, in substance, cash flows from a call option with strike price $X on an asset is equivalent to the combined cash flow from the underlying asset and a put option with strike price $X on the asset, less cash of $X.) Differences in articulation can give rise to a range of plausible treatments. An insurer remains responsible for justifying its choice of treatment after discussion with its auditor. Opinions expressed in the working papers are not representative of that of the Singapore Actuarial Society.

Table of Contents

1. IFRS17 Standards

Paragraph 11
An entity shall:

(b) separate from a host insurance contract an investment component if, and only if, that investment component is distinct (see paragraphs B31–B32). The entity shall apply IFRS 9 to account for the separated investment component.

Paragraph 12
After applying paragraph 11 to separate any cash flows related to embedded derivatives and distinct investment components, an entity shall separate from the host insurance contract any promise to transfer distinct goods or non-insurance services to a policyholder, applying paragraph 7 of IFRS 15.

Paragraph 13
After applying paragraphs 11–12, an entity shall apply IFRS 17 to all remaining components of the host insurance contract. Hereafter, all references in IFRS 17 to embedded derivatives refer to derivatives that have not been separated from the host insurance contract and all references to investment components refer to investment components that have not been separated from the host insurance contract (except those references in paragraphs B31–B32).

Paragraph 32
On initial recognition, an entity shall measure a group of insurance contracts at the total of:

(a) the fulfilment cash flows, which comprise:
(i) estimates of future cash flows (paragraphs 33–35);

Paragraph 34
Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services.

Paragraph B31
Paragraph 11(b) requires an entity to separate a distinct investment component from the host insurance contract. An investment component is distinct if, and only if, both the following conditions are met:

(a) the investment component and the insurance component are not highly interrelated.
(b) a contract with equivalent terms is sold, or could be sold, separately in the same market or the same jurisdiction, either by entities that issue insurance contracts or by other parties. The entity shall take into account all information reasonably available in making this determination. The entity is not required to undertake an exhaustive search to identify whether an investment component is sold separately.

Paragraph B32
An investment component and an insurance component are highly interrelated if, and only if:

(a) the entity is unable to measure one component without considering the other. Thus, if the value of one component varies according to the value of the other, an entity shall apply IFRS 17 to account for the combined investment and insurance component; or
(b) the policyholder is unable to benefit from one component unless the other is also present. Thus, if the lapse or maturity of one component in a contract causes the lapse or maturity of the other, the entity shall apply IFRS 17 to account for the combined investment component and insurance component.

Paragraph B96

For insurance contracts without direct participation features, paragraph 44(c) requires an adjustment to the contractual service margin of a group of insurance contracts for changes in fulfilment cash flows that relate to future service. These changes comprise:

(b) changes in estimates of the present value of the future cash flows in the liability for remaining coverage, except those described in paragraph B97(a), measured at the discount rates specified in paragraph B72(c);

(c) differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period, measured at the discount rates specified in paragraph B72(c); and

Paragraph BC114

The Board considered whether to permit an entity to separate a non-insurance component when not required to do so by IFRS 17; for example, some investment components with interrelated cash flows, such as policy loans. Such components may have been separated when applying previous accounting practices. However, the Board concluded that it would not be possible to separate in a non-arbitrary way a component that is not distinct from the insurance contract nor would such a result be desirable. Permitting an entity to separate such components would mean that the entity measures the components in the contract on an arbitrary basis. The Board also noted that when separation ignores interdependencies between insurance and non-insurance components, the sum of the values of the components may not always equal the value of the contract as a whole, even on initial recognition. That would reduce the comparability of the financial statements across entities.

Paragraph BC108

Accordingly, IFRS 17 requires an entity to:

(a) separate only any distinct investment components from insurance contracts. An investment component is distinct if the cash flows of the insurance contract are not highly interrelated with the cash flows from the investment component. Separating such components does not create the problems noted in paragraph BC10(a).

(b) account for all investment components with cash flows that are highly interrelated with the insurance contract by applying IFRS 17, but, as explained in paragraphs BC33–BC34, eliminate any investment components from insurance revenue and insurance service expenses reported in accordance with paragraph 85 of IFRS 17.

Paragraph B120

The total insurance revenue for a group of insurance contracts is the consideration for the contracts, ie the amount of premiums paid to the entity:

(a) adjusted for a financing effect; and

(b) excluding any investment components.

Paragraph B123 (Exposure Draft June 2019)

Consistently, applying IFRS 17, when an entity provides services in a period, it reduces the liability for remaining coverage for the services provided and recognises insurance revenue. The reduction in the liability for remaining coverage that gives rise to insurance revenue excludes changes in the liability that do not relate to services expected to be covered by the consideration received by the entity. Those changes are:

(a) changes that do not relate to services provided in the period, for example:

(ii) changes that relate to investment components in the period;

<u>(iia) changes resulting from cash flows from loans to policyholders;</u>

2. Interpretation of Standards

This paper focuses on non-distinct investment component and non-insurance components that are not separated from the host insurance contract. The key passages in the IFRS17 standards that relate to the qualification and treatment of these components are outlined below:

Standard	Interpretation
Appendix A	**Investment component definition** Investment component is defined as the amounts that an entity needs to repay to a policyholder even if an insured event does not occur. In the Exposure Draft issued in June 2019, it is updated to be the amount repayable to policyholder under all circumstances. For **APD,** it could be argued as not fitting the definition of investment component, since there are scenarios when no amount is repaid in all circumstances; the balance is used for paying premium instead of as an inherit value to be repaid in future. In addition, any amount repaid (premium refund at policy termination) is not considered as investment component according to April TRG paper AP01. However, other views would regard the APD balance as investment component if it is treated as belonging to policyholder irrespective of if they use it to pay premium eventually or not. For **policy loan**, it may be argued that it is not an investment component since the future cash flow is not a repayment to policyholder, but an amount owed by the policyholder to the entity. On the other hand, it can also be argued that it is a negative adjustment to the original investment component, hence can be considered as part of investment component in arriving at the final "net" investment amount. Note that without clarification from IASB, it would be difficult to conclude this item as BC114 implies policy loan as an investment component while B123 from June Exposure Draft specifically separates policy loan from the rest of investment components when listing items that are not related to current period services.
34	**Criteria of inclusion as a "contract"** Paragraph 34 can be referenced when determining if a component are in the scope of the contract, hence be subjected to valuation under IFRS 17. For the particular component to be qualified as part of the "contract" (hence its cash flow to be included as part of fulfillment cash flow), it should create substantive rights and obligation from both parties to receive premium or provide service. Else, the component can be argued as not qualified as part of a "contract" hence not subjected to IFRS 17.
11-13, BC108, BC114,	**Separation of components from host insurance contract** In determining the scope of contract under IFRS17, paragraphs 11-13 specifically mention that company is only required to separate any embedded derivatives, distinct investment component, distinct goods and non-insurance services from the host insurance contract. The remaining components would need to be measured under IFRS17 as an insurance contract. Regarding separating out non-insurance service which is not required by the standard, BC114 states that it is not recommended to split them out in an arbitrary way that could possibly ignore interdependencies between the components, which could lead to inconsistency measurement compared to if they were not split out.

	These paragraphs could serve as a reference when determining whether Policy loan or APD can be interpreted as distinct investment or non-insurance components. For some particular components, company may exercise judgement in determining whether the component packaged / issued in a way that is distinct from the host insurance component, while not ignoring the degree of interrelation to the insurance component.
B31, B32	**<u>Criteria to qualify as distinct investment component to be separated</u>** An investment component can be classified as distinct, hence required to be separated out, only if it fulfills the conditions that it is not highly interrelated with the insurance component and that a contract with equivalent terms as the investment component can be separately sold in the market. For the first condition regarding interrelation, the investment component is considered to be highly interrelated to the host component either when their value cannot be calculated independently without considering the other, or the termination of one component will trigger the termination of the other.
32, B96	**<u>Treatment of policy loans and non-distinct investment components – Initial and subsequent measurement</u>** Paragraph 32 states that at initial recognition all future cash flow within the contract boundary should be included in the measurement of contract liability as part of fulfilment cash flow. This means the future cash flow projection of all components not separated from the base insurance component (including non-distinct investment components and other non-insurance components) should be projected with the insurance benefit outgo with decrement and be included in liability. This would cause any expected future spread earned in future from these components to alter the amount of initial CSM. In subsequent period, B96b states that changes in fulfilment cash flow relating to future service and changes in investment component from current period expected vs actual difference would both adjust CSM. For non-insurance components, depending on the measurement model and the nature of future cash flow adjustment (financial/non-financial), the change could either adjust CSM or go to PnL.
BC108, B123	**<u>Treatment of policy loans and non-distinct investment components – Presentation</u>** For presentation, BC108 states investment component should be removed from the insurance revenue and service expense section (disaggregation) as any receipts and repayment in relation to these components are irrelevant to revenue recognition and service provided. For Policy Loan according to B123 (updated in the June 2019 Exposure Draft), when service is provided in each period, changes in future obligation due to loan service should also be removed from the insurance revenue and service expense section (disaggregation).

3. How it applies to Singapore

From above, we can see that except for components that are embedded derivatives, distinct investment or goods and non-insurance components that meet the criteria specified in B31 & 32 or B34 & 35 respectively, the rest of components should be combined with host insurance contract and measured under IFRS17. Specifically, below are description and treatment for **APD, policy loans and major non-distinct components**:

Components	Description and classification	Treatment
1) APD	**Description** Advance Premium Deposit gives policyholders a choice to prepay premium to company in advance, on which they can earn a specified deposit rate. The prepaid amount can be used to pay future premium, and will be returned to policyholder upon contract termination or upon policyholder withdrawal. **Classification - Case1/Case 2** If APD were to be argued as distinct component as Case 1, would need to justify by either one of below. Otherwise it has to fall under Case 2: • the deposit facility is packaged / issued in a way that is legally and contractually distinct from the host insurance contract, hence out of IFRS 17 scope, OR • the deposit facility does not imply a substantive rights and obligations from both parties to receive premium or provide obligated return (e.g. guaranteed interest return) on the premium, that renders APD not being a part of "contract", OR • APD is classified as an investment component and subsequently satisfies the distinct investment component criteria under B31: o *Whether it is able to be measured independently from the insurance component (B32 condition 1)* o *Whether it is possible to be repaid upon policyholder's demand without the insurance component being terminated. (B32 condition 2)* o *Whether deposit with similar*	**<u>Case 1:</u>** If it is classified as • not under IFRS17 scope or • a distinct investment component Then it should be separated from host insurance contract and measured under IFRS9. **<u>Case 2:</u>** If it is classified as non-distinct investment/non-investment component: **Initial recognition** At inception, fulfilment cash flow should include: ❖ Prepaid premium at inception, ❖ Accumulated prepaid premium account returned to policyholders projected in addition to insurance benefit outgo with decrement. Accumulated rate is at APD rate ❖ Premium outgo deducted from prepaid account when there is premium due ❖ Projected policyholder withdrawal of the prepaid premium Time zero BE liability contributed by the prepaid facility would be sum of PV of future APD spreads, where each spreads is the excess of earned interest over APD rate at each projected period. This amount, usually positive, will contribute to increase initial CSM. **Subsequent Measurement** Future prepaid premium included in liability is un-winded in same way as other insurance liability cash flow as premiums become due. Changes in future fulfillment cash flow

	terms (e.g. specific premium deposit rate, deposit amount) could be sold separately in the market. (B31 condition 2) Nevertheless the **degree of cash flow interrelation with the insurance cash flow** needs to be taken into account according to BC114, which any existing interrelation would result in failure to consider the components separately. In general, the feature of the APD facility would tend to create future cash flow that is dependent on the insurance contract terms (e.g. maximum deposit amount, crediting interest, expected premium drawdown schedule, refund timing etc). This can be considerations to argue for APD to be treated under Case 2.	amount would • adjust CSM for contracts under *VFA model*. Or • either adjust CSM or go to PnL depending on whether if it is caused by a financial related risk or change for contracts under *GM model* CSM contributed by the APD is amortized with the rest of CSM over lifetime of the contract by appropriate coverage unit. **Presentation** If APD were to be classified as an investment component, release of liability relating to APD does not contribute to revenue recognition under the Insurance Revenue and Service Expense section. (B123) Due to APD being a financing facility, benefit cash flow corresponding to services provided by the entity should be adjusted by the APD cash flow before being included under the Insurance Revenue and Service Expense section. (Consider B120 as a requirement on revenue presentation.) Any variance due to prepayment receipt changes would adjust CSM with the impact being amortized out under the Insurance Revenue section according to pattern of service provided.
2) Policy Loan	**Description** Policy loans provide options for policyholders of contracts with cash value to borrow money at the expense of the cash value, which the amount borrowed, is deducted from the surrender/death benefit when the contract eventually terminates. The loan amount and availability could vary with product type. **Classification** It may not fit into the definition of investment component, nevertheless the standard (BC114) implies that it should not be separated from other insurance components and considered as part of liability as the rest of insurance contract.	**Initial recognition** Given that loan could be taken up and repaid by any specific policyholder at any random duration, assumptions such as loan timing, loan take up rate, repayment timing and repayment amount needs to be established. At inception, fulfilment cash flow should include: ❖ Expected loan face amount outgo at loan inception based on assumed take up rate and timing ❖ Future loan reversal cash flow at charged interest rate, which is deducted from insurance benefit payout with decrement applied. ❖ Projected policyholder voluntary

	Policy loan has interdependencies with the host insurance contract in terms of cash flow timing (when incorporating future loan repayment cash flow into fulfillment cash flow, the amount of present value of the loan component will depend on the timing of base contract decrements) and assumptions (e.g. discount rate, max loan limit etc). Hence there would not be a non-arbitrary way to separate the loan out while maintaining same aggregate value compared to if it were not separated out. Hence it would need to remain with the insurance contract under IFRS17.	repayment of the loan Time zero BE liability contributed a projected loan would be sum of PV of future loan spreads, where loan spreads is the excess of charged interest over required interest at each projected period. This amount, usually positive, will contribute to increase initial CSM. **Subsequent measurement** Future loan cash flow included in liability is un-winded in same way as other insurance liability cash flow as loan is repaid according to expected decrement or repayment schedule. Changes in loan repayment cash flow (e.g. change in interest rate charged) would • Adjust CSM for contracts under *VFA model*. Or • Either adjust CSM or go to PnL depending on whether if it is caused by a financial related risk or change for contracts under *GM model*. CSM contributed by the loan is amortized with the rest of CSM over lifetime of the contract by appropriate coverage unit. **Presentation** Release in liability relating to policy loan should not be included under the Insurance Revenue and Service Expense section. (Disaggregation requirement as stated in B123 in Exposure Draft June 2019)
3) Other non-distinct investment componen t	Surrender value, Amount on Deposit, ROP[1], no claims bonuses[2], account value under a savings type product etc. They are investment components that do not qualify paragraph B31 & B32 to be distinct.	**Initial recognition** *Similar to 1) APD case 2* **Subsequent measurement** *Similar to 1) APD case 2* **Presentation** *Similar to 1) APD case 2*

[1] ROP: Note that the returned premium here refers to premium past due and paid, instead of return of any unused premium.

[2] Need to ensure the bonuses under discussion should not be used subsequently to pay any outstanding premium, in case no claim is made.

Implementation and Simplification
From implementation point of view, incorporating certain investment component into fulfillment cash flow could require extensive modelling enhancement and create operational complexity. For example under current framework, APD, policy loans etc may not be modelled or treated together with other liability cash flow.

Company may adopt alternate simplified modelling method with justification. For example, the company might choose “balance” approach with no assumption on future potential loan take up rate, loan repayment rate etc. Instead of projecting future cash flow for APD and Policy Loan, the company might simply adjust asset and liability for APD and Policy Loan balance, ignoring future spreads earned.

The company might choose to justify the approach by showing that the alternate approach would generate results reasonably close to the standard-inferred approach. The company remains responsible for justifying its choice of treatment after discussion with its auditor.