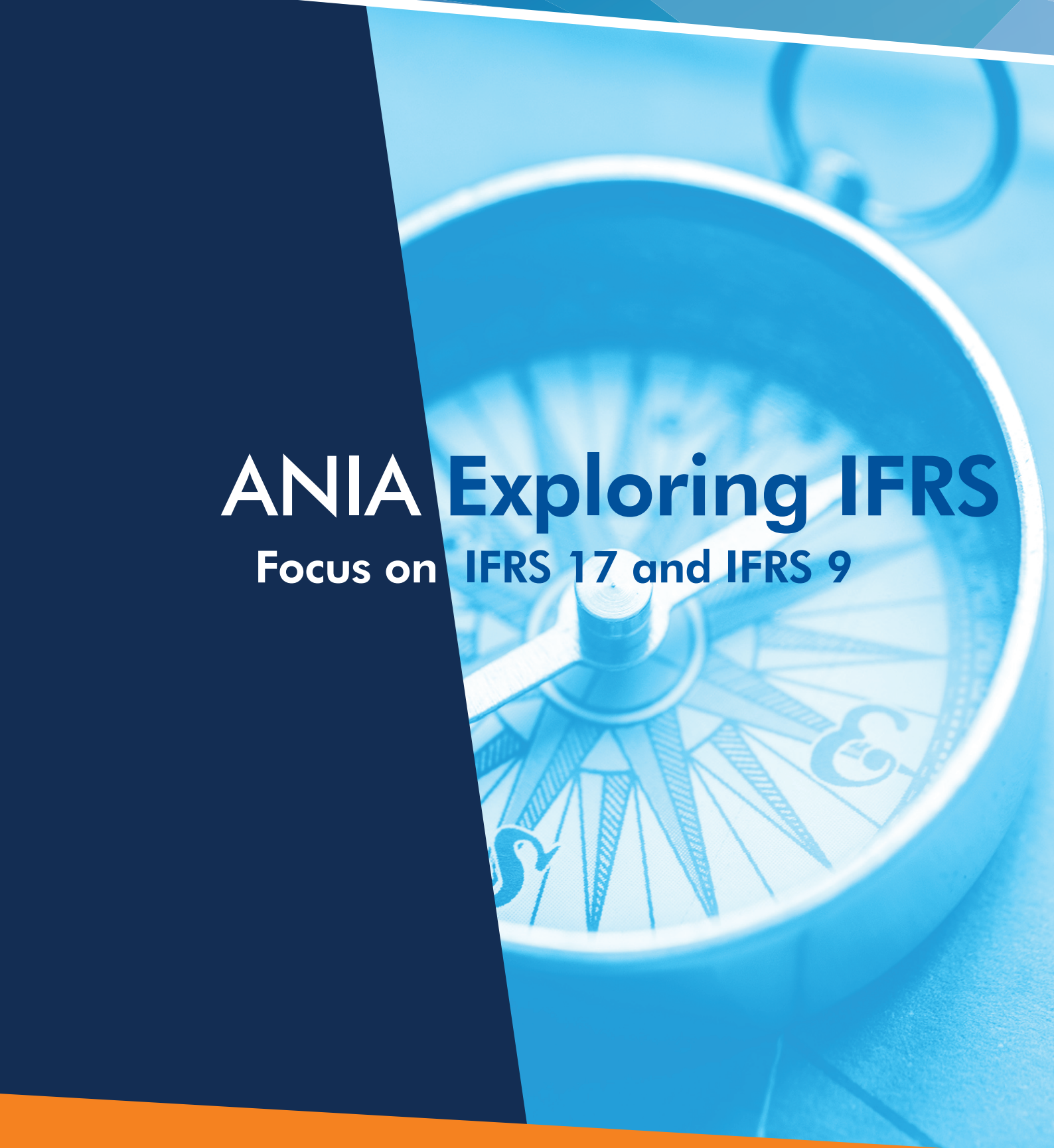
Ania
Associazione Nazionale
fra le Imprese Assicuratrici

2021 Edition

ANIA Exploring IFRS

Focus on IFRS 17 and IFRS 9



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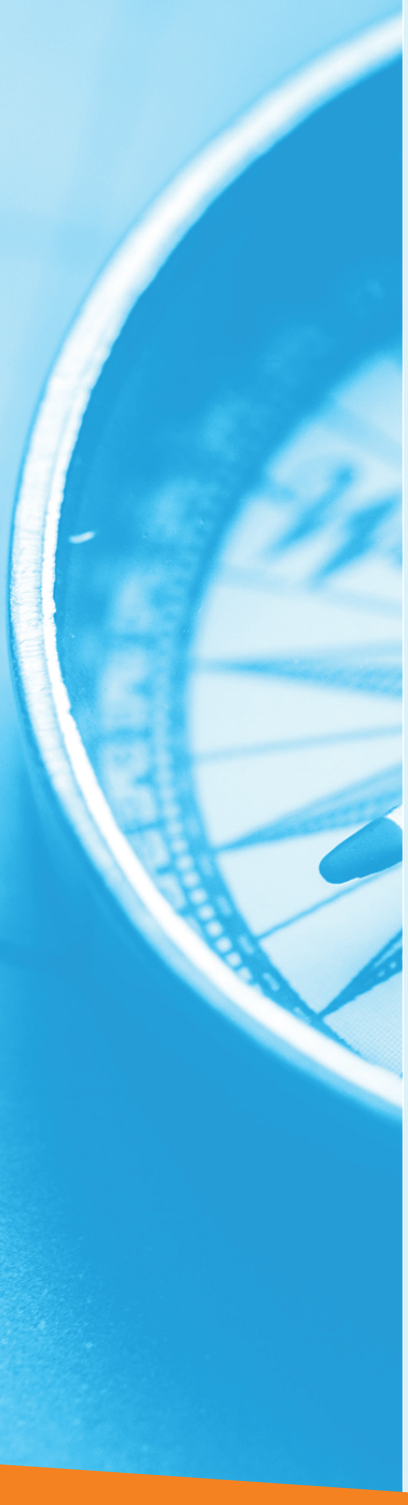

*In light of the forthcoming "revolution" of the accounting framework of the insurance sector, brought forward by the adoption of IFRS 17 "Insurance Contracts" principle, ANIA has decided to launch a new series of newsletter: "**ANIA Exploring IFRS**".*

The aim of "ANIA Exploring IFRS" is to provide useful insights on the International Financial Reporting Standards world, with an initial focus on IFRS 17.

The series will then continue by addressing other standards relevant for the insurance industry, such as - but not limited to - IFRS 9 "Financial Instruments" principle.

The newsletters will be issued on a regular basis, in a one-page format, and each issue will focus on specific features of the IFRS principle in question.

The newsletters will be collected in a single volume to form a practical - and easy to use - reference guide.

Angelo Doni
ANIA Co-Director General

IFRS 17: Endorsement Process

1 MARCH, 31 2021

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Entry-into-force

The entry into force of IFRS 17 "Insurance Contracts" was originally set as of 1 January 2021.

In March 2020, however, the International Accounting Standards Board (IASB) decided to postpone the **effective date** to annual reporting periods beginning on - or after - **1 January 2023**, with the aim of allowing sufficient time for an orderly introduction of the new principle.

In order to **align the dates of implementation of IFRS 9 and IFRS 17**, the IASB decided at the same time to extend the exemption in place for the application of IFRS 9 "Financial Instruments" by insurers.

In June 2020, the IASB issued the amended version of IFRS 17, containing the new effective date of 1 January 2023.

European endorsement process

In order to become applicable in the European Union, **IFRS principles have to be endorsed at European level** following a specific procedure, as set out in Regulation (EC) No 1606/2002 (IAS Regulation).

The endorsement process is carried out by the **European Commission (EC)**, that avails itself of **two advisory organisations**: the European Financial Reporting Advisory Group (**EFRAG**) and the Accounting Regulatory Committee (**ARC**).

The process starts with EFRAG, which is required to render an opinion to the EC on the compliance of the standard with the requirements set forth by EU regulation. The three endorsement criteria to be met are: i) the standard should not be contrary to the true and fair view principle; ii) the standard should be conducive to the European public good; iii) the standard should meet the criteria of understandability, relevance, reliability, and comparability.

After EFRAG has submitted its advice, the EC prepares and presents a draft regulation to ARC, a committee composed of representatives of EU countries and chaired by the EC. The ARC subsequently gives its opinion - voting on the basis of the qualified majority rule - on the endorsement of the standard.

If the ARC's opinion is positive, **the EC submits the draft regulation to the European Parliament** and the **Council** for a three-month scrutiny period. If there are no objections from the European Parliament or the Council, the Commission adopts the endorsing regulation.

The new regulation is then published in the Official Journal of the European Union and enters into force on the day laid down in the regulation itself.

As for IFRS 17, **on 29 March 2021 the EFRAG Board approved its final endorsement advice**.

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2 APRIL, 9 2021

IFRS 17: Main objectives

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The new standard for insurance contracts, **IFRS 17**, aims to **increase transparency** and to **reduce differences in the accounting** for insurance contracts. If IFRS 4 allows insurers to use their local accounting standards, IFRS 17 defines rules that will **increase financial statements' comparability**.

The new standard will replace the current IFRS 4 and, therefore, key financial metrics and key performance indicators will change.

Premium volumes will no longer drive the 'top line' in the income statement because investment components (many insurance premiums include an investment, i.e. deposit, component) and cash received can no longer be considered as revenues.

The 'top line' will be driven by **a different way to represent revenues**, and consequently, the new measurement model may result in profits being released over significantly different patterns for some insurance contracts with respect to the current IFRS 4 representation.

The impact that financial risks and investment income have on an insurer's results will be presented separately from insurance performance, with the aim to provide a clearer picture of profit drivers and to give a separate presentation of underwriting and financial results.

In addition, IFRS 17 contains **detailed qualitative and quantitative disclosure requirements**. The objective is to disclose information that - together with information presented in the primary financial statements - provides a basis for users of the financial statements to assess the effects that insurance contracts have on the financial position, the financial performance and the cash flows of the entity.

To achieve this objective, IFRS 17 requires specific disclosures about:

- **Amounts recognized in the financial statements;**
- **Significant judgments made when applying IFRS 17;** and
- **The nature and extent of risks from insurance contracts**.

If these specific disclosures are deemed insufficient, an entity has to disclose additional information necessary to meet the objective.

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IFRS 17: Scope

3 APRIL, 14 2021

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In line with **IFRS 4**, an entity applies **IFRS 17** to contracts that meet the insurance contract's definition. **IFRS 17 focuses on types of contracts, rather than types of entities**. Therefore, it applies to all entities, whether they are regulated as insurance entities or not.

An **insurance contract** is "*a contract under which one party - the issuer - accepts 'significant insurance risk' from another party - the policyholder.*" If a *"specified uncertain future event - the insured event - adversely affects the policyholder*", then the policyholder has a right to obtain compensation from the issuer under the contract.

'**Insurance risk**' is a risk, other than financial risk, that is transferred from the policyholder to the issuer of a contract.

Insurance risk is "significant" only if there is a scenario that has commercial substance in which, on a present value basis, there is a possibility that an issuer could:

- suffer a loss caused by the insured event; and
- pay significant additional amounts beyond what would be paid if the insured event had not occurred.

To have commercial substance, it must have a discernible effect on the economics of the transaction. A contract is not an insurance contract if it exposes the issuer only to financial risk but not to significant insurance risk. However, contracts that expose the issuer to both financial risk and significant insurance risk could be insurance contracts.

Reinsurance contracts need to meet the definition of an insurance contract to be in the scope of IFRS 17.

Investment contracts with Discretionary Participation Features (DPF) are in the scope of IFRS 17 if they are issued by an entity that issues also insurance contracts even if they do not transfer significant insurance risk. A DPF contract is a financial instrument that provides an investor with a contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts that are:

- expected to be a significant portion of the total contractual benefits;
- contractually paid at the discretion of the issuer (regarding timing or amount); and
- contractually based on returns from a specified pool of contracts/ assets.

Insurers are subject to the requirements of other applicable standards for products (or components of products) that are not in the scope of IFRS 17.

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4 APRIL, 22 2021

IFRS 17: Separating components

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Insurance contracts create a bundle of rights and obligations that work together to generate a package of cash flows.

While some types of **insurance contracts** provide exclusively insurance coverage that falls under IFRS 17, **others** - e.g. unit-linked and other participating contracts - **may contain one or more components.** Were these components separate contracts, they would be **within the scope of other IFRS standards**.

Some insurance contracts may contain:

- ***investment components***: e.g. pure deposits, such as financial instruments whereby an entity receives a specified sum to be repaid with interests;
- ***good and service components***: e.g. services other than insurance contract services, such as pension administration, risk management services, asset management, or custody services;
- ***embedded derivatives***: e.g. financial derivatives, such as interest rate options or options linked to an equity index.

Investment components and goods and services components have to be separated from an insurance contract, **if they are distinct**, and will follow respectively "IFRS 9- Financial Instruments" and "IFRS 15 - Revenue from Contracts with Customers".

Additionally, IFRS 9 is applied to determine when an embedded derivative needs to be separated from the host insurance contract and to be accounted for separately.

If the components are not distinct, then the separation is prohibited under IFRS 17.

As for **good and service components**, they are considered distinct if the insurance contract holds a promise to provide goods or services - other than the insurance contract service - and if the policyholder can benefit from the goods or services either:

- on their own; or
- with other resources that are readily available to the policyholder - i.e. resources that were already obtained or are sold separately by the entity or any other entity.

Goods or services other than insurance contract services are not distinct and are accounted for together with the insurance component, if:

- the cash flows and risks associated with the good or service are highly inter-related with the cash flows and risks of the insurance component; and
- the entity "*provides a significant service of integrating the good or service with the insurance components*".

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IFRS 17: Investment component

5 APRIL, 30 2021

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An "*investment component*" represents the amount an entity has to repay - according to an insurance contract - in all circumstances, even if the insured event does not occur. These include circumstances in which an insured event occurs, or the contract matures or terminates without an insured event occurring.

If "distinct", an investment component has to be **separated from the insurance contract** and **accounted for according to "IFRS 9- Financial Instruments" requirements**.

The investment component **is distinct if**:

- this component and the insurance component **are not "*highly inter-related*"**; and
- **a contract with equivalent terms is sold or could be sold separately in the same market or same jurisdiction**. An entity takes into account all reasonably available information when it makes this assessment, but it does not have to undertake an exhaustive search.

Investment and insurance components are "*highly inter-related*" if:

- a policyholder cannot benefit from one component without the other being present - e.g. the lapse or maturity of one component causes the lapse or maturity of the other; or
- the entity cannot measure one component without considering the other - e.g. when the value of one component varies according to the other's value.

The separated investment component is accounted for under IFRS 9 unless **it is an investment contract with discretionary participation features in the scope of IFRS 17**.

Investment components that are not distinct from the insurance contract are not separated and **are accounted for together with the insurance component**.

Notwithstanding that, it should be noted that:

- revenue and claims from the non-distinct investment components are excluded from insurance contract revenue and insurance service expenses presented in profit or loss;
- differences between any non-distinct 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 determined on initial recognition, adjust the Contractual Service Margin of a group of insurance contracts.

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6 MAY, 6 2021

IFRS 17: Initial recognition

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An entity **recognises a group of issued insurance contracts** from **the earliest** of the following:

- **the beginning of the coverage period** of the group of contracts;
- **the date when the first payment from a policyholder in the group becomes due**; and
- for a group of onerous contracts, **when the group becomes onerous**, if facts and circumstances indicate that there is such a group.

If there is no due date specified in the contract, the initial recognition of a group of insurance contracts is the date when the first payment is received from the policyholder.

A group of contracts initially recognised in a reporting period only includes contracts that individually meet one of the recognition criteria above. **New contracts may be added to the group**, in subsequent reporting periods in which any new contracts are recognised, subject to the level of aggregation requirements.

The date on which an entity recognises a group of insurance contracts is relevant for the following reasons:

- **determining the Contractual Service Margin** (CSM);
- **determining the discount rate on initial recognition**.

The determination of the CSM and the discount rate on initial recognition is affected by the level of aggregation of contracts used to form a group.

For **reinsurance contracts** held, an entity shall recognise a group:

- if the reinsurance contracts held provide proportionate coverage: at the beginning of the coverage period of the group of reinsurance contracts held or at the initial recognition of any underlying contract, whichever is the latest; and
- in all other cases: from the beginning of the coverage period of the group of reinsurance contracts held.

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IFRS 17: Level of Aggregation

7 MAY, 13 2021

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The definition of the level of aggregation of insurance contracts is required for all contracts in the scope of IFRS 17 and determines the **unit of account** to be used when applying IFRS 17. The groups are established **at initial recognition** and are not reassessed subsequently.

An entity should initially identify **portfolios** of insurance contracts. **A portfolio of insurance contracts is defined as insurance contracts subject to similar risks and managed together**. It is generally expected that contracts in different product lines will have different risks. For example, single-premium fixed annuities and regular term life insurance contracts are expected to be in different portfolios, because they cover different insurance risks (longevity and mortality).

According to the Standard, as issued by the IASB, an entity cannot include contracts issued more than one year apart in the same group. Therefore, each portfolio should be disaggregated into **annual cohorts**, or cohorts consisting of periods of less than one year.

An entity divides **each portfolio into a minimum of**:

- a group of contracts that are **onerous** on initial recognition, if there are any;
- a group of contracts that, on initial recognition, have **no significant possibility of becoming onerous subsequently**, if there are any; and
- a group of any **remaining contracts** in the portfolio.

According to the goal of the new accounting principle to immediately recognize in P&L the effects of the onerous contracts, the grouping of individual contracts under IFRS 17 is performed in a way that limits the offsetting of profitable contracts against onerous ones, having regard to how insurers manage and evaluate the performance of their business.

The level of aggregation requirements of insurance contracts in IFRS 17 constitute a significant change to today's financial reporting practices and the annual cohorts requirements is still under discussion in the current European endorsement process.

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8 MAY, 20 2021

IFRS 17: Onerous Contract Test

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In the aggregation process of insurance contracts, a fundamental step is the identification of the profitability level of the contracts within each portfolio/cohort on initial recognition.

An entity may measure whether contracts are **onerous on initial recognition** for **sets of contracts** - i.e. at a higher level of aggregation than the individual contract level - if it has reasonable and supportable information to conclude that a set of contracts are in the same group. Likewise, an entity may assess whether contracts have **no significant possibility of becoming onerous subsequently** for **sets of contracts** - i.e. at a higher level of aggregation than the individual contract level - if it has reasonable and supportable information to conclude that a set of contracts are in the same group. **If the entity cannot support such a conclusion**, then **the entity determines the group by assessing individual contracts**.

The assessment that contracts have **no significant possibility of becoming onerous subsequently** may be performed:

- **by using information about estimates** provided by the entity's internal reporting; and
- **based on the likelihood of changes in assumptions** that, if they occurred, would result in the contracts becoming onerous.

Once the entity has identified the onerous contracts and contracts with no significant possibility of becoming onerous subsequently, contracts are classified into different groups. **If there are any, the remaining contracts are included in a group of the remaining contracts in the portfolio (profitable contracts)**.

In some cases, **law or regulation explicitly constrains** the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics. **Only in such cases, the entity may include those contracts in the same group**.

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IFRS 17: Overview of the General Model

9 MAY, 28 2021

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The **General Model** aims to provide **relevant information** about the **expected cash flows** and **profitability** of insurance contracts. In fact, the **main goal** of this general measurement model, introduced by IFRS 17, is to give a comprehensive and coherent framework that provides information r**eflecting the many different features of insurance contracts and the ways in which the issuers of insurance contracts earn income** from them.

On initial recognition, the liability (or asset) recognised for a group of insurance contracts is measured as the **sum of**:

- **the fulfilment cash flows**, which are a risk-adjusted, explicit, unbiased and probability-weighted estimate of the present value of expected cash flows that will arise as the entity fulfils the contracts; and
- **the contractual service margin (CSM)**, which is the amount that represents the **unearned profit that the entity will recognise in profit or loss as services are provided**.

At initial recognition, for profitable groups of contracts, the CSM has an equal and opposite value to the fulfilment cash flows. This is because, at initial recognition, the entire value of the contracts relates to services to be provided over the life of the unit of account and, therefore, profit to be released to Profit or Loss at each reporting date (unless change in profitability).

If the total mentioned above **is a net cash outflow**, then **the group of contracts is onerous**. **A loss is recognised immediately in the statement of financial performance** for the entire net cash outflow.

After inception, the fulfilment cash flows are reassessed and **remeasured at each reporting date**, using current assumptions, identifying those changes that are part of insurance revenue, insurance service expense and insurance finance income or expense. The **CSM is allocated to profit or loss** as a component of revenue.

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10 JUNE, 4 2021

IFRS 17: Cash Flow

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The first step in measuring a group of contracts is the estimation of cash flows.

IFRS 17 requires estimates of expected cash flows of a group of insurance contracts:

- to **incorporate all reasonable and supportable information** that is available without undue cost or effort about the amount, timing and uncertainty of those expected cash flows in an unbiased way;
- to **include all the expected cash flows within the boundary** of each contract within the group;
- to reflect the perspective of the entity, provided that, when relevant, the estimates are **consistent with observable market prices**; and
- to be **current and explicit**.

The expected cash flows **may be estimated at a higher level of aggregation and then allocated** to groups of contracts.

The requirement to incorporate in the estimates all reasonable and supportable information (without undue cost or effort about the amount, timing and uncertainty of expected cash flows) is achieved by estimating the expected value of the full range of possible outcomes - i.e. the probability - weighted mean.

The risk adjustment for non-financial risk is included explicitly as a separate component of the measurement.

The contract boundary distinguishes the expected cash flows related to existing insurance contracts from those related to future insurance contracts.

The contract boundary is reassessed at each reporting date and, therefore, may change over time.

Cash flows within the boundary of an insurance contract **are those that relate directly to the fulfilment of the contract**, and include those over which the entity has discretion including, for example, premiums, payments, claims and costs.

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IFRS 17: Discount Rate

11 JUNE, 14 2021

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The second step in measuring a group of contracts is discounting to reflect the time value of money and financial risks associated with the cash flows.

The discount rate applied to cash flow should:

- be consistent with observable current market prices;
- reflect the time value of the money, the characteristics of the cash flows and liquidity characteristics of the insurance contracts;
- exclude the effects of factors that affect observable market prices used in determining the discount rate, but do not affect the expected cash flows of the insurance contract.

Cash flows that vary based on the return on the underlying items are discounted or adjusted to reflect that variability, regardless of whether:

- the variability arises from contractual terms or discretion of the issuer; or
- the entity holds the underlying items.

An entity determines the discount rate based on an estimation technique, if:

- observable market prices with the same characteristics (e.g. timing, currency, liquidity) are not available; or
- similar instruments are available but do not separately identify factors of the financial instrument that differentiate it from the insurance contract.

IFRS 17 does not prescribe a single estimation technique to derive discount rates. However, the standard does specify that **a 'top-down' or 'bottom-up' approach may be used**:

- "***Bottom-up***": an entity may determine the discount rate based on a liquid risk-free yield curve. This is adjusted to eliminate differences between the liquidity characteristics of the financial instruments that underlie the chosen curve and those of the insurance contracts;
- "***Top-down***": an entity may determine the discount rates based on a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets. The yield curve is adjusted to eliminate any factors that are not relevant to the insurance contracts.

The effect of, and changes in, the time value of money and financial risk (including that arising from the passage of time) are presented as insurance finance income or expense or in the statement of financial performance, applying specific accounting policies.

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12 JUNE, 21 2021

IFRS 17: Risk Adjustment

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The third step in measuring a group of insurance contracts is **to adjust the present value of expected cash flows for non-financial risk**. The risk adjustment conveys information to users of the financial statement about **the amount the entity charges for bearing the uncertainty over the amount and timing of cash flows arising from non-financial risk**. In particular, it measures the compensation that the entity would require to make it indifferent between:

- fulfilling a liability that has a range of possible outcomes arising from non-financial risk; and
- fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contract.

IFRS 17 does not prescribe specific methodologies for determining the risk adjustment for non-financial risk. Therefore, management's judgement is necessary to determine an appropriate risk adjustment technique to use.

While the appropriateness of the methodology will depend on the individual circumstances and on the techniques currently used by each entity, there are some relevant **characteristics that may be generally considered**, such as the frequency and the severity of the claims, the duration of the contracts, the uncertainty of the estimates.

The different methodologies that may be used may include - among others - the cost of capital or a confidence level.

While leaving the choice on whether or not to use a confidence level technique to determine the risk adjustment, IFRS 17 prescribes that, in case **an entity chooses not to use it, the entity has to disclose the confidence level corresponding to the results of that technique to provide comparability**. This provision might significantly influence the choice of the approach to be used and might present operational challenges.

The risk adjustment is then periodically released in profit or loss in accordance with insurance coverage provided.

In line with the other components of the fulfilment cash flows, **the risk adjustment for non-financial risk is revised at each reporting date** on the basis of updated assumptions.

When applying IFRS 17, a company will also be required to disclose a reconciliation of the movement in the risk adjustment from the opening balance to the closing balance.

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IFRS 17: Contractual Service Margin

13 JUNE, 28 2021

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The Contractual Service Margin (CSM) determination is the final step in measuring a group of insurance contracts on initial recognition. It **represents the unearned profit that the entity will recognise as it provides services over the coverage period** under the insurance contracts in the group.

The CSM cannot be negative for insurance contracts issued.

On initial recognition of a profitable group of insurance contracts, the CSM is the equal and opposite amount of the net inflow that arises from the sum of the following:

- the fulfilment cash flows;
- the derecognition of any asset or liability previously recognised for cash flows related to the group; and
- any cash flows arising from contracts in the group at that date.

For loss-making groups of insurance contracts, the CSM **is set equal to zero** and losses must be immediately recognised in profit or loss.

An entity calculates a CSM for each group of insurance contracts.

At each **subsequent reporting date**, the carrying amount of a group of insurance contracts is remeasured by:

- **estimating the fulfilment cash flows using current assumptions**; and
- **updating the CSM to reflect changes in fulfilment cash flows related to future services**, a financing effect and the profit earned as insurance contract services are provided in the period. The updated CSM represents the profit that has not yet been recognised in profit or loss because it relates to future services to be provided.

The sum of the updated fulfilment cash flows and the updated CSM represents the carrying amount of the group of insurance contracts at each reporting date.

The CSM is released in each reporting period for an amount recognised in profit or loss to reflect the insurance contract services provided under the group of insurance contracts in that period.

In order to do that, the entity should first **identify the coverage units in the group**, meaning 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.

The amount is then determined by **allocating the CSM at the reporting date equally to coverage units provided** in the current period and expected to be provided in the future. Finally, **the portion of the CSM allocated to the current period should be recognised in profit or loss**.

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14 JULY, 5 2021

IFRS 17: Onerous Contracts

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On initial recognition **a group of insurance contracts is onerous if the sum of the fulfilment cash flows allocated to the contracts, any previously recognised insurance acquisition cash flows and any cash flows arising from the contracts, results in a net cash outflow**.

The carrying amount of the insurance liability for a group that is onerous at initial recognition is equal to the fulfilment cash flows, and **the CSM of the group is zero. The loss has to be recognised immediately in Profit and Loss** for the entire net cash outflow.

Once a group of contracts has a loss component as part of its liability for remaining coverage (either on initial recognition or subsequently), **subsequent changes in the fulfilment cash flows** of that liability are **allocated on a systematic basis** between the:

- loss component of the liability for remaining coverage; and
- liability for remaining coverage, excluding the loss component.

These **subsequent changes** are those **estimates of the present value of expected cash flows for claims and expenses released from the liability for remaining coverage** because of incurred insurance service expenses, changes in the risk adjustment for non-financial risk recognised in profit or loss due to the release from risk, and insurance finance income or expense.

The systematic allocation results in the total amounts allocated to the loss component being zero by the end of the coverage period of the group of contracts.

Subsequent decreases in fulfilment cash flows arising from changes in estimates of expected cash flows relating to future service **and**, for contracts with direct participation features, any **subsequent increases in the amount of the entity's share of the fair value of the underlying items, are allocated solely to the loss component until it is reduced to zero**. After it has reached zero, a CSM is created for the excess of the decrease over the amount allocated to the loss component.

A group of contracts that has a CSM on initial recognition can become onerous in subsequent periods, if any of the following exceeds the carrying amount of the CSM:

- unfavourable changes relating to future service in the fulfilment cash flows arising from changes in estimates of expected cash flows and the risk adjustment for non-financial risk; and
- for contracts with direct participation features, a decrease in the amount of the entity's share of the fair value of the underlying items.

The excess is the loss component of the liability for remaining coverage and is recognised in profit or loss when it is first measured.

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IFRS 17: Eligibility for the Variable Fee Approach

15 JULY, 12 2021

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Many insurers issue contracts including features that share returns on underlying items with the policyholders. IFRS 17 draws a distinction between contracts with direct participation features, contracts with participation features which are not direct and other non-participating insurance contracts.

An insurance contract is considered to be a **direct participating contract** when:

- the contractual terms specify that **the policyholder participates in a share of a clearly identified pool of underlying items**;
- **the entity expects to pay the policyholder an amount equal to a substantial share of the fair value returns** on the underlying items; and
- the entity expects a **substantial proportion of any change in the amounts to be paid** to the policyholder to **vary with the change in the fair value of the underlying items**.

When evaluating the contractual terms, it is important to consider that **a clearly identified pool of underlying items does not exist when**:

- **an entity can change the underlying items** that determine the amount of the entity's obligation with retrospective effect; or
- **there are no underlying items identified**, even if the policyholder could be provided with a return that generally reflects the entity's overall performance expectations or the performance expectations of a subset of assets that the entity holds.

Moreover, the term "**substantial**" **has to be evaluated in the context of the objective of direct participating contracts**, and the variability in these amounts is considered over the duration of the insurance contract and on a present value, probability-weighted average basis.

When a contract meets the requirements to be defined as a direct participating contract, the entity **must apply** the measurement model approach called "**Variable Fee Approach**" (VFA).

In conclusion, direct participating contracts create an obligation to pay the policyholder an amount equal to the fair value of the underlying items, apart from a variable fee for the future services provided. The **variable fee** is equal to the difference between the entity's share in the fair value of the underlying items and the fulfilment cash flows that do not vary based on the underlying items.

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IFRS 17: Applying the Variable Fee Approach

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At initial recognition of a direct participation group of contracts, **the measurement** under the Variable Fee Approach (VFA) **is the same as the General Measurement Model** (GMM). **On subsequent measurement, differences arise:** the VFA modifies the GMM treatment of the contractual service margin (CSM) in order to include modifications that reflect the specific nature of direct participating contracts. In particular, the differences with respect to the GMM reflect the notion that the entity substantially provides investment-related services to the policyholder and is compensated for the services by a fee determined with reference to the underlying items.

At each subsequent reporting date, the CSM of a group of direct participating insurance contracts is remeasured, updating the previous reporting date CSM **to reflect**:

- **changes in estimates of the fulfilment cash flows** related to future services;
- **the entity's share of the change in the fair value** of the underlying items;
- **the amount recognised as insurance revenue** because of the transfer of services in the period, determined by the allocation of the CSM remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period, applying coverage units.

Changes in the obligation to pay the policyholder an amount equal to the fair value of the underlying items are recognised in Profit or Loss or in Other Comprehensive Income (**OCI**). However, as explained above, **changes in the amount of the entity's share of the fair value of the underlying items** relate to future services and, therefore, **adjust the CSM, except** to the extent that:

- the amount of **the entity's share of a decrease in the fair value** of the underlying items **exceeds the carrying amount of the CSM**, resulting in a loss recognised as part of the insurance service result;
- **the amount of the entity's share of an increase in the fair value** of the underlying items **reverses losses previously recognised**; or
- **the entity meets the conditions for the risk mitigation option** and chooses not to reflect in the CSM some or all of the changes in the effect of financial risk on its share of the underlying items.

Entities do not need to identify the adjustments to the CSM for the changes in the entity's share of the change in the fair value of the underlying items **separately from those related to changes in the fulfilment cash flows relating to future service**. Therefore, they can adjust the CSM for an amount equal to the change in the fair value of underlying items, less the change in the fulfilment cash flows.

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IFRS 17: Premium Allocation Approach

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The Premium Allocation Approach (PAA) is an **optional** and **simplified measurement model** that can be used when certain criteria are met. In particular, **an entity is permitted to apply the PAA** to measure a group of insurance contracts **if**, at inception of the group:

- **the coverage period** of each contract in the group of insurance contracts **is one year or less**; or
- the entity reasonably expects that **the PAA would produce a measurement of the liability for remaining coverage** for a group of insurance contracts **that would not materially differ from the** measurement that would be achieved by applying the **general measurement** requirements.

Under the PAA, the general measurement model is simplified to measure the liability for remaining coverage.

At inception, the PAA measures **the liability for remaining coverage as the amount of premiums received less the acquisition cash flows paid**.

After the initial recognition, the liability for remaining coverage **increases with premiums received and decreases to reflect an allocation of the amount** of premiums and acquisition cash flows **that have been recognised in profit or loss** over the expired portion of the coverage period based on the passage of time. The insurance contract revenue for the period is the amount of expected premium receipts allocated to the period itself. **The allocation to each period** of insurance contract services **is based on the passage of time**. However, in case the pattern of the release of risk during the coverage period differs significantly from the passage of time, the expected premium receipts are to be allocated to periods of coverage based on the expected timing of incurred insurance service expenses.

The PAA assumes that recognising the contract's premium over the coverage period provides information and profit patterns similar to those provided by recognising insurance contract revenue measured using the general measurement model. The initial measurement of the liability for remaining coverage does not explicitly identify the present value of expected cash flows, the effects of risk, and the time value of money. Consequently, **the subsequent measurement does not involve analysing the variations in those components before a claim is incurred** because the rationale for applying the PAA is that it is unlikely to have significant changes in them. However, **when facts and circumstances indicate that a group of contracts is onerous, the entity calculates the loss component using the general measurement model's** fulfilment cash flow requirements.

The liability for incurred claims is measured for contracts under the PAA as the amount of the fulfilment cash flows relating to incurred claims, **according to the general measurement model's** fulfilment cash flow **requirements**.

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ANIA, the Italian Insurance Association,
founded in 1944, is a voluntary non-profit association.
Its main purpose is to develop and spread the culture of safety
and prevention in our country, so as to protect both people
and companies, and society as a whole, more and better.

Moreover, ANIA represents its members and the Italian insurance market
vis-à-vis the main political and administrative institutions, including the
Government and Parliament,
trade unions and other social bodies.

The Association studies and cooperates in the resolution
of technical, economic, financial, administrative, fiscal, social, juridical and
legislative issues concerning the insurance industry.
It supports and provides technical assistance to members,
promotes the education and professional training of those
working in the insurance sector.

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