EFRAG
European Financial Reporting Advisory Group

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EFRAG IAWG Report to EFRAG TEG – February 2019

Objective and Introduction

1 The objective of this session is for EFRAG TEG:
   - (a) to receive the views of the EFRAG IAWG relating to:
     - (i) questions that EFRAG TEG raised at its February 2019 meeting;
     - (ii) the January 2019 IASB's tentative decisions and EFRAG IAWG's views on how they should impact the draft comment letter on the forthcoming Exposure Draft proposing amendments to IFRS 17 *Insurance Contracts* and/or the future draft endorsement advice on a revised IFRS 17; and
   - (b) to consider whether EFRAG TEG has any questions for the EFRAG IAWG in respect of EFRAG IAWG's discussions on the January 2019 IASB's tentative decisions.

2 For the questions raised by EFRAG TEG, some EFRAG IAWG members provided their responses in writing to a questionnaire sent by the EFRAG Secretariat. Most additional input has been incorporated in the summary below. One lengthy answer on hedge accounting has been summarised in Appendix 2 of this paper.

3 In addition to this paper, agenda paper 07-02 – *2014 EFRAG hedging survey and results* – has been provided for the session as background information.

Agenda for the 28 February 2019 EFRAG IAWG meeting

4 EFRAG IAWG discussed the questions from EFRAG TEG at its February 2019 meeting relating to:
   - (a) Presentation of insurance contracts on the statement of financial position;
   - (b) Discount rates;
   - (c) Future cash flows in the measurement of reinsurance contract held; and
   - (d) Variable fee approach: Risk mitigation exception.

5 EFRAG IAWG also discussed the IASB's tentative decisions made at the IASB meeting in January 2019 on the following topics:
   - (a) Acquisition cash flows for renewals outside the contract boundary;
   - (b) Contractual service margin: coverage units in the general model;
   - (c) Variable fee approach: limited applicability of the risk mitigation exception;
   - (d) Reinsurance contracts held: initial recognition when underlying insurance contracts are onerous; and
   - (e) Reinsurance contracts: ineligibility for the variable fee approach.

6 For each of the issues considered by the IASB EFRAG IAWG was asked for their views, and the reasons for those views, quantified where relevant, on:

  (a) Where the IASB has tentatively decided to make amendments to the Standard, how should the IASB's proposed changes be considered in developing the comment letter on the forthcoming Exposure Draft; and

  (b) Where the IASB has tentatively decided *not* to make amendments to the Standard, the impact of the IASB's tentative decisions on the technical endorsement criteria of relevance, reliability, comparability, understandability and prudence as well as other criteria considered in developing an endorsement advice such as the impact on the cost-benefit relationship.

7 The reasoning of the IASB staff in recommending a change or not to the IASB is provided in Appendix 1 of this paper.

Feedback on questions from EFRAG TEG

8 EFRAG TEG members asked for feedback on the following issues:

  (a) Presentation of insurance contracts on the statement of financial position;

  (b) Discount rates;

  (c) Future cash flows in the measurement of reinsurance contract held; and

  (d) Variable fee approach risk mitigation exception.

Presentation of insurance contracts in the statement of financial position

9 EFRAG TEG asked EFRAG IAWG to provide further information, separately for premiums receivable and claims payable, on:

  (a) Nature of the issue: whether it is limited to presentation or comprises both presentation and measurement;

  (b) Definitions of premiums receivable and claims payable used in practice;

  (c) Nature of presentation concerns relating to reinsurance;

  (d) Conceptual reasons for disagreeing with the IASB not to amend IFRS 17, if any. If the issue relates to cost/benefit, what is the cost and how do you assess the benefit;

  (e) The nature and extent of credit risk in premiums receivable given the restrictions to provide insurance cover during periods where premiums are due.

Discussion

PREMIUMS RECEIVABLE

10 The definitions of premiums receivable currently used included:

  (a) An unconditional right to receive premiums due which may include premiums due over more than one reporting period (the European Accounts Directive mentions premiums due);

  (b) Any overdue premium as per the terms of the contract; and

  (c) The next contractually due premium which may include future instalments (i.e., there is a forward view of premiums).

11 EFRAG IAWG members indicated that premiums receivable also include amounts due from brokers/intermediaries/agents and sometimes this receivable includes premiums that the policyholder has already paid. One EFRAG IAWG member considered that premiums receivable from brokers should not be included in the fulfilment cash flows because contractually they may have received the premiums

from the policyholders so there may be credit risk associated with the broker/intermediary/agent.

12 Responding to a question on what would happen if premiums are not paid by the policyholder, some members stated that it would depend on whether or not the policyholder has the right to lapse (for short-term contracts usually a policyholder has the obligation to pay the premium), a policyholder could also choose not to pay and the contract is cancelled or several options could be given to the policyholder. For life insurance, there are a number of different options made available to policyholders, e.g., for a term insurance policy, the policy would lapse but if it was a savings product like unit-linked contracts, the cover could continue as there is a unit fund supporting benefits.

13 Based on the written responses, one member indicated that credit risk for premiums in life business is typically minimal however credit risk for general insurance can be more significant because premiums are often collected by intermediaries such as brokers. However, the short duration of receivables due from intermediaries means that credit risk is not normally material.

14 Some EFRAG IAWG members and an observer indicated that the issue was not only a presentation issue but could also impact measurement in the following cases:

(a) If significant changes occur in the collection of the premiums after the related receivables have been moved out of the actuarial system into the collections system. If these were included in the fulfilment cash flows, they would create a measurement difference.

(b) Experience adjustments are recognised in profit or loss (if related to current period) or the contractual service margin ('CSM') (if related to the future periods) on a group basis, entities would have to have this granularity for the receivables which is complex to manage.

(c) The CSM is adjusted for future expectations relating to receivables, e.g. timing and credit risk associated with receipts and therefore, this adjustment would have to be done at a group level rather than portfolio level thus affecting measurement.

15 Some EFRAG IAWG members stated that the cash, receivables, accounting and actuarial systems are not currently integrated. The cash and receivable systems are managed on individual contract level while the actuarial system works with model points. If premiums are not paid, the receivables are written-off (and revenue is decreased). In the accounting system, if policyholders do not pay their premiums, adjustments are done at contract level. The actuarial system is forward looking and is not affected by receivables (it assumes policyholders pay premiums when due). One EFRAG IAWG member mentioned that broker balances are managed at a broker level and not at contract level.

16 One EFRAG IAWG member indicated that it is not expected that preparers will invest in linking their systems for IFRS 17 purposes therefore the auditors will need to verify that any differences are within their materiality threshold.

17 Another EFRAG IAWG member stated that some preparers currently include premiums receivable in their insurance obligation while others treat premiums receivable separately and do an impairment test.

<u>CLAIMS PAYABLE</u>

18 Some members stated that the issues on claims payable are similar to that of premiums receivable.

19 Some members indicated that a claim payable arises when a payment has been determined and approved but there is a timing issue. Claims payable do not include IBNR. It was acknowledged that there was a short time between determination of

the claim and payment of the claim to the policyholder so it may not be material. Some other members indicated that it could be long-term, such as when the insurer does not know who to pay and the beneficiary does not claim. One written response indicated that for life insurance, most claims are settled quickly but for general insurance, claims are settled more slowly.

20 Some members stated that it becomes complicated when there is a netting arrangement for example in reinsurance and settlement could take between three to six months or even longer.

21 One member stated that there are some accrued costs and accrued expenses (currently a payable) which are currently known at a high level (i.e. cost centre level). It is a cost payable and not a claims payable. However, it would be complex to link this payable to the liability calculation.

REINSURANCE PRESENTATION CONCERNS

22 On reinsurance, the discussion focussed on the fact that reinsurance is often settled on a net basis (e.g. on a quarterly basis) but the requirements of IFRS 17 mean the disclosures and calculations are done on a gross basis. Participants commented that the concerns are similar to the ones on premiums receivable with funds withheld as a complicating factor.

23 On funds withheld, a user perspective was that netting normally reduces information value but supported the IFRS 17 method as it shows the real net coverage and the real risk position which was perceived as a positive. Another member did not agree with this assessment.

24 The following were concerns raised in the written responses of two members:

(a) where profit commissions mean a minimum is payable to the cedant in all scenarios, this would create an investment component. The presentation will be difficult to understand for users of the financial statements, as premiums and claims will be netted down by an amount which might be payable only in most unlikely circumstances.

(b) It is practice to settle all payables and receivables from different contracts net on a current account basis. However, the net amount would need to be allocated to claims payable or premiums receivable in order to identify, whether a portfolio is in a net asset or liability position.

Discount rates

25 EFRAG TEG asked EFRAG IAWG to provide further information on:

(a) Its assessment of comparability in the context of discount rates used in estimating the insurance liability or estimating the risk adjustment in the context of EIOPA's concerns[1];

(b) How to determine discount rate for non-participating contracts when future outflows do not depend on underlying items and whether required disclosures on discount curve are sufficient to ensure comparability.

Discussion

26 One member commented that the requirement for the discount rate to reflect the characteristics of the cash flows of the liability is very important to portray the liability

[1] EIOPA's report on IFRS 17 states: "IFRS 17's requirements on determining the applicable discount rate and risk adjustment may have exceeded the appropriate level of entity-specific inputs and consequently may give rise to significantly different and potentially incomparable results." The full report is available at: https://eiopa.europa.eu/Publications/Reports/EIOPA-18-717_EIOPA_Analysis_IFRS_17_18%2010%202018.pdf

appropriately. More prescriptive guidance may result in deceptive comparability but would not be useful.

27 Another member agreed that it is useful that the characteristics of cash flows and risks are reflected, however that member opined that disclosures of sensitivities may not be sufficient for users and that the replicating portfolio allowed under Solvency II is not useful as a user wants to understand the entity-specific asset/liability risk factors rather than for the industry as a whole.

28 It was noted that some regulators are considering publishing monthly risk-free interest rate curves to be used by insurers in their IFRS 17 calculations with a comply or explain requirement. Furthermore, some are considering mandating either a top-down or bottom-up approach for use in their territories. It was also noted that the risk margin for non-financial risk was never intended to be comparable as it is an entity-specific measure intended to provide insight into how risk is viewed, measured and managed by the entity rather than for consistency of calculation.

29 Based on the written responses, members stated that they either did not agree with the concerns raised by EIOPA or subjectivity is addressed by disclosures.

30 For determining the discount rate for non-participating contracts, based on the written responses:

(a) One member indicated that they would apply a discount rate based on the actual assets held reduced for a market participant view of credit risk; and

(b) Another member stated that they planned to apply a process/method consistent with Solvency II.

31 In the written responses, one member considered that the disclosures provided on the discount curve will be sufficient to ensure comparability.

Future cash flows in the measurement of reinsurance contract held

32 EFRAG TEG asked EFRAG IAWG to provide further information on a possible risk adjustment mismatch between underlying contracts and reinsurance contracts held.

Discussion

33 Answers included that different risks (or only some of the risks) may be reinsured, resulting in differing diversification benefits; differing contract boundaries and uncertainty as to whether risk adjustment includes the risk of non-performance of reinsurer or not. Also the inclusion of cashflows on business not written yet, leads to accounting mismatches when discount rates change.

34 Additional written information received was that one member expected to use a cost of capital approach similar to Solvency II. This requires a risk margin net of reinsurance. To meet the IFRS 17 requirements it would be necessary to scale up the net amount to gross and ceded business. The respondent noted that an issue could arise from the different contract boundaries for underlying contracts and reinsurance contracts held but notes that this may not be material.

Variable fee approach - risk mitigation exception

35 EFRAG TEG asked EFRAG IAWG to provide further information on:

(a) Hedging strategies currently used such as risks generally hedged and hedging instruments used;

(b) Hedging strategies expected including risks expected to be hedged and hedging instruments used;

(c) Mismatches arising from current and expected strategies; and

(d) Reasons why IFRS 9 *Financial Instruments* hedging cannot be used, if that is the case.

Discussion

36 An EFRAG IAWG member referred to the 2014 EFRAG hedging survey (see Agenda Paper 07-02). Other comments from EFRAG IAWG members included:

(a) The reasons giving rise to the carve-out from IAS 39 *Financial Instruments: Recognition and Measurement* for banks are also relevant for insurers;

(b) Guarantees that cannot be unbundled under IFRS 4 due to the interrelated nature with insurance risk give rise to the same problems under IFRS 9/IFRS 17 as under IFRS 4/IAS 39.

(c) Fixed interest rate securities may be used as hedging instruments for the variable fee approach (hence the concern about only allowing reinsurance contracts and derivatives for risk mitigation); and

(d) The non-retrospective application of risk mitigation on transition is a concern.

37 An observer suggested that where something is currently unbundled under IFRS 4 this should by definition be separately identifiable and measurable under IFRS 9 for hedge accounting. The observer acknowledged that, as hedge accounting results in changing the normal rules of accounting, applying hedge accounting requires significant effort.

38 It was agreed that EFRAG IAWG members would further investigate the impact of IFRS 9 in this regard and provide feedback as and when available, but that this preliminary feedback would be reported to EFRAG TEG.

39 Members that provided written information on their **current hedging strategies** noted the following:

40 One member did not apply hedge accounting directly to insurance liabilities. However, that member has two different approaches to address the accounting effects of economic hedging programs:

(a) Hedge accounting is used to hedge reinvestment risk ultimately stemming from traditional life insurance business (today accounted for with locked-in assumptions):

(i) All-in-one hedge accounting for forward bond purchases.

(ii) Cash flow hedge accounting using forward starting swaps.

(b) The option in IFRS 4 is used to unbundle guarantee features embedded in certain unit-linked contracts ("variable annuities") and measure those guarantee features at FVPL. This provides a natural offsetting with the derivatives in profit or loss.

41 One member noted its current hedging strategy is to hedge its Solvency II Surplus Ratio. This is done through swaps (interest rate risk), equity puts (equity risk), reinsurance (insurance risk). Hedge accounting under IAS 39 is not applied.

42 Members that provided written information on their **planned hedge strategies** under IFRS 9/ IFRS 17 noted the following:

43 One respondent noted:

(a) For traditional life insurance:

(i) For some contracts, the derivatives are underlying items shared with the policyholder. IFRS 17 provides a natural hedge as the changes in the derivative are reflected in cash flows to policyholders and CSM, even without formal hedge accounting. This may broaden the scope of hedging activities being applied for such products due to lower restrictions and less operational burden.

(ii) For non-VFA contracts, the situation remains like today (no reflection of changes in options and guarantees in P&L), but the current hedge accounting strategies still work.

(b) For variable annuities: The unbundling option in IFRS 4 does not exist under IFRS 17. This respondent notes to apply the risk mitigation option for VFA contracts instead.

44 One member noted that hedging is currently on a Solvency II basis and does not intend to change this for the introduction of IFRS 9 / IFRS 17.

Questions for EFRAG TEG

45 Does EFRAG TEG have any comments on the feedback from the EFRAG IAWG?

46 Does EFRAG TEG have any issues that they would like to raise with the EFRAG IAWG?

Acquisition cash flows for renewals outside the contract boundary

47 EFRAG IAWG members discussed the IASB's tentative decision to:

(a) allocate to any expected contract renewals their related part of the insurance acquisition cash flows directly attributable to newly issued contracts;

(b) recognise the insurance acquisition cash flows allocated to expected contract renewals as assets applying paragraph 27 of IFRS 17 until the renewed contracts are recognised;

(c) assess the recoverability of any asset recognised applying paragraph 27 of IFRS 17 each period before the related contracts are recognised. The recoverability assessment would be based on the expected fulfilment cash flows of the related group of contracts;

(d) recognise a loss in profit or loss for any unrecoverable carrying amounts of the asset recognised by applying paragraph 27 of IFRS 17. The definition of insurance acquisition cash flows, the contract boundary requirements and the unit of account of IFRS 17 will not be affected by the amendment; and

(e) recognise in profit or loss the reversal of some or all of any such loss previously recognised when the impairment conditions no longer exist or have improved.

Input into draft comment letter on the forthcoming ED - main takeaway

48 All EFRAG IAWG members present agreed with the IASB's tentative decisions.

Discussion

49 There were no specific comments made.

Questions for EFRAG TEG

50 Does EFRAG TEG agree that the IASB's tentative decisions should be supported in the draft comment letter on the forthcoming Exposure Draft?

51 Does EFRAG TEG have any issues that they would like to raise with the EFRAG IAWG?

Contractual service margin: coverage units in the general model

52 EFRAG IAWG members discussed the IASB's tentative decision:

(a) to amend IFRS 17 so that in the general model the CSM is recognised in profit or loss on the basis of coverage units that are determined by considering both insurance coverage and investment return service, if any;

(b) to amend IFRS 17 to establish that an investment return service exists only when an insurance contract includes an investment component;

(c) to amend IFRS 17 to require an entity to use judgement applied consistently in deciding whether an investment return service exists when determining coverage units, and not provide an objective or criteria for that determination. However, the IASB instructed the IASB staff to consider including in the Basis for Conclusions some of the analysis in the IASB paper, to indicate what such judgements might involve;

(d) to amend IFRS 17 to establish that the period of investment return services should be regarded as ending when the entity has made all investment component payments to the policyholder of the contract and should not include any period of payments to future policyholders;

(e) to amend IFRS 17 to require assessments of the relative weighting of the benefits provided by insurance coverage and investment return services and their pattern of delivery to be made on a systematic and rational basis;

(f) to confirm that, applying IFRS 17, cash flows relating to fulfilling the investment return service are included in the measurement of the insurance contract;

(g) not to change the requirements of IFRS 17 relating to changes in fulfilment cash flows that adjust the CSM in the general model; and

(h) to amend IFRS 17 to establish that the one-year eligibility criterion for the premium allocation approach should be assessed by considering insurance coverage and an investment return service, if any.

Input into draft comment letter on the forthcoming ED - main takeaway

53 EFRAG IAWG members indicated that the IASB was moving in the right direction but further work needed to be done to make the amended requirements work in practice.

<u>Discussion</u>

54 Some EFRAG IAWG members indicated that there are situations where there is an investment-related service but no investment component but there were also policies where there is an investment component but there are no investment-related services. One member suggested that an investment component could be applicable as a rebuttable presumption.

55 An example was mentioned of a policy where an entity would not be able to apply the amended requirements is the UK bulk annuities where liabilities of a pension scheme are transferred to an insurance company and there are deferred annuities where there is no guaranteed annuity payment and therefore no investment component. It would depend if there is a clear account balance or not to define the investment component.

56 It was questioned what service is being provided to the policyholder if the policyholder does not always benefit from the investment-related services. It is not clear, from the perspective of the policyholder, if there is any promise and what that promise could be.

57 Some members considered that profits should be recognised in the accumulation phase and not only during the insurance coverage period. One member stated that if there is no investment component, it was unclear whether, it would mean that the whole coverage period is insurance coverage.

Questions for EFRAG TEG

58 Does EFRAG TEG agree that the IASB's tentative decisions should be supported in the draft comment letter on the forthcoming Exposure Draft?

59 Does EFRAG TEG have any comments on the feedback from the EFRAG IAWG?

60 Does EFRAG TEG have any issues that they would like to raise with the EFRAG IAWG?

Variable fee approach: limited applicability of the risk mitigation exception

61 EFRAG IAWG discussed the IASB's tentative decision in January 2019 to include reinsurance contracts held in the instruments that can apply the risk mitigation approach where these mitigate financial risks. This follows on from the IASB's December 2018 decision not to amend IFRS 17 to permit an entity to account for reinsurance contracts it holds applying the variable fee approach when the underlying insurance contracts are insurance contracts with direct participation features.

62 The concern that led to the IASB's tentative decision is that IFRS 17 could give rise to mismatches and therefore, similarly to the risk mitigation allowed for derivatives, reinsurance contracts that mitigate financial risk should be treated in the same way.

Discussion

63 EFRAG IAWG members felt that this was an improvement but did not necessarily go far enough. The concern was raised that the CSM mismatch is not necessarily resolved (for example when there is a difference in contract boundary between the reinsurance contracts and the underlying insurance contracts. This may also affect the discount rates used for both types of insurance contracts). In addition, the solution does not cover situations where non-derivative instruments are used to economically hedge the risk position.

64 The concerns related to retrospective application would continue and that whilst this solves the concern about reinsurance contracts not qualifying for variable fee approach for the insurer (in an intra-group situation), it does not necessarily do so for the reinsurer.

Questions for EFRAG TEG

65 Does EFRAG TEG agree that the IASB's tentative decisions should be supported in the draft comment letter on the forthcoming Exposure Draft?

66 Does EFRAG TEG have any comments on the feedback from the EFRAG IAWG?

67 Does EFRAG TEG have any issues that they would like to raise with the EFRAG IAWG?

Reinsurance contracts held: initial recognition when underlying insurance contracts are onerous

68 EFRAG IAWG members discussed the following tentative decisions of the IASB to amend IFRS 17 to:

(a) expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognises losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and

(b) require an entity to apply the expanded exception when the entity measures contracts applying the premium allocation approach.

Discussion

69 EFRAG IAWG members were generally positive about the tentative decisions taken which would help especially direct insurers with external reinsurance. In addition to this the following comments were made.

70 Proportional reinsurance: practice would have to determine what proportional reinsurance meant as it was more than only quota-share reinsurance. Also, the situation where direct insurance was reinsured through both proportional and non-proportional reinsurance would have to be analysed.

71 Risk-mitigation and non-proportional reinsurance: a simulation was needed covering all possible situations from an insurer's and reinsurer's perspective including the link with risk-mitigation. Also, further accounting solutions were to be developed for non-proportional reinsurance.

Questions for EFRAG TEG

72 Does EFRAG TEG agree that the IASB's tentative decisions should be supported in the draft comment letter on the forthcoming Exposure Draft?

73 Does EFRAG TEG have any comments on the feedback from the EFRAG IAWG?

74 Does EFRAG TEG have any issues that they would like to raise with the EFRAG IAWG?

Reinsurance contracts: ineligibility for the variable fee approach

75 EFRAG IAWG discussed the IASB's tentative decision in January 2019 not to amend IFRS 17's requirement that reinsurance contracts held or issued are not eligible for the variable fee approach.

Discussion

76 There was a concern that the accounting would not reflect the economics: An intra-group example was provided where with-profits business is written off-shore which is then a 100% reinsured to an on-shore reinsurer. The reinsurer receives fees for capital support, the cost of smoothing and fund management activity, all of which are expressed as a percentage of assets under management. The rationale for the reinsurance is that it enables the insurer to transact business while benefiting from the capital strength, investment management expertise and brand of the reinsurer. The EFRAG IAWG member believes that the reinsurance would meet the requirements of Paragraph B101, i.e. the contractual terms specify that insurer participates in a share of a clearly identified pool of underlying items; the reinsurer expects to pay to the insurer an amount equal to a substantial share of the fair value returns on the underlying items; and the reinsurer expects a substantial proportion of any change in the amounts to be paid to insurer to vary with the change in the fair value of the underlying items. However, paragraph B109 of IFRS 17 would preclude such business from qualifying for the variable fee approach. This will result in a significant inconsistency between the measurement of the direct business and the reinsurance asset on the balance sheet of insurer.

77 There was a comment that the accounting would be unbalanced if the reinsurer does not have the underlying assets and it was not clear what the benefit would be as the intention of the variable fee approach is to mirror the assets underlying the contract.

78 An observer noted that documentation of common control reinsurance and the implicit CFO Forum solution that requires variable fee approach accounting by the reinsurer if holding the underlying assets would be useful.

Questions for EFRAG TEG

79 Does EFRAG TEG have any comments on the feedback from the EFRAG IAWG?

80 Does EFRAG TEG have any issues that they would like to raise with the EFRAG IAWG?

Appendix 1: Summary and reasoning of IASB Staff paper positions

Introduction

81 The appendix summarises the reasoning of the IASB staff in recommending whether or not the IASB should make a change to IFRS 17.

Acquisition cash flows for renewals outside the contract boundary

82 The IASB staff recommended the IASB to amend IFRS 17 to require an entity to:

(a) allocate to any anticipated contract renewals part of the insurance acquisition cash flows directly attributable to newly issued contracts.

(b) recognise the insurance acquisition cash flows allocated to anticipated contract renewals as an asset applying paragraph 27[2] of IFRS 17 until the renewed contracts are recognised.

(c) assess the recoverability of the asset recognised according to paragraph 27 of IFRS 17 each period before the related contracts are recognised. The recoverability assessment would be based on the expected fulfilment cash flows of the related group of contracts.

(d) recognise a loss in profit or loss for any unrecoverable carrying amounts of the asset recognised by applying paragraph 27 of IFRS 17.

(e) recognise in profit or loss the reversal of some or all of any such loss previously recognised when the impairment conditions no longer exist or have improved.

83 The IASB staff observed that:

(a) the outcome of applying the current IFRS 17 requirements may not be viewed as reflecting the economic substance of these transactions. Entities may incur substantial acquisition costs to obtain a contract, in the expectation that the contract will be renewed and that the acquisition costs will be recovered over the life of the contract and over its renewals.

(b) the outcome of applying the requirements in IFRS 17 may differ from that which may be achieved in arguably similar circumstances applying IFRS 15. However, they noted that the requirements of IFRS 15 for incremental costs of obtaining a contract that relate to an anticipated contract renewal are not directly comparable to the requirements in IFRS 17 because of differences in:

(i) the scope and definition of acquisition costs;

(ii) the measurement approach; and

(iii) approach to assessing impairment.

84 The IASB staff did not recommend to seek consistency with IFRS 15 for a number of reasons, for example because this would add complexity for both preparers and users of financial statements and may unduly disrupt implementation.

85 In the light of the concerns expressed by stakeholders, the IASB staff considered that amending IFRS 17 as suggested in paragraph 82 above:

[2] Paragraph 27 of IFRS 17 (reflecting amendments the IASB has tentatively decided to propose as part of the annual improvement process) requires an entity to recognise an asset or liability for any insurance acquisition cash flows relating to a group of insurance contracts issued or expected to be issued that the entity pays or receives before the group is recognised.

(a) could provide useful information for users of financial statements, without unacceptably reducing understandability of financial statements; and

(b) might not unduly disrupt implementation processes that are already under way given it is based on the existing requirements of IFRS 17.

Contractual service margin: coverage units in the general model

86 The IASB staff recommended the IASB to:

(a) amend IFRS 17 so that in the general model the CSM is allocated on the basis of coverage units that are determined by considering both insurance coverage and any investment return service;[3]

(b) amend IFRS 17 to establish that an investment return service can exist only when an insurance contract includes an investment component;

(c) amend IFRS 17 to require an entity to use judgement applied consistently in deciding whether to include an investment return service when determining coverage units, and not provide an objective or criteria for that determination;

(d) amend IFRS 17 to establish that the period of investment return services should be regarded as ending when the entity has made all investment component payments to the policyholder of the contract, i.e. not including payments to future policyholders;

(e) amend IFRS 17 to require the assessments of the relative weighting of the benefits provided by insurance coverage and investment return services and their pattern of delivery to be made on a systematic and rational basis;

(f) confirm that, applying IFRS 17, cash flows relating to fulfilling the investment return service are included in the measurement of the insurance contract;

(g) not to change the requirements in IFRS 17 relating to which changes in fulfilment cash flows adjust the CSM in the general model; and

(h) amend IFRS 17 to establish that the one year eligibility criterion for the premium allocation approach should be assessed by considering insurance coverage and an investment return service, if any.

87 The IASB staff observed that:

(a) the outcome of applying the current IFRS 17 requirements may not be viewed as reflecting the economic substance of these transactions. Entities may incur substantial acquisition costs to obtain a contract, in the expectation that the contract will be renewed and that the acquisition costs will be recovered over the life of the contract and over its renewals.

(b) the outcome of applying the requirements in IFRS 17 may differ from that which may be achieved in arguably similar circumstances applying IFRS 15. However, they noted that the requirements of IFRS 15 for incremental costs of obtaining a contract that relate to an anticipated contract renewal are not directly comparable to the requirements in IFRS 17 because of differences in:

    (i) the scope and definition of acquisition costs;

    (ii) the measurement approach; and

    (iii) approach to assessing impairment.

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[3] The IASB staff will consider in drafting whether to replace the term ‘coverage units’ with ‘service units’.

88 The IASB staff did not recommend to seek consistency with IFRS 15 for a number of reasons, for example because this would add complexity for both preparers and users of financial statements and may unduly disrupt implementation.

89 In the light of the concerns expressed by stakeholders, the IASB staff considered that amending IFRS 17 as suggested in paragraph 82 above:

(a) could provide useful information for users of financial statements, without unacceptably reducing understandability of financial statements; and

(b) might not unduly disrupt implementation processes that are already under way given it is based on the existing requirements of IFRS 17.

Variable fee approach: limited applicability of the risk mitigation exception

90 The IASB staff recommended that the IASB amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features in paragraph B115 of IFRS 17 so that the exception applies when an entity uses a derivative or a reinsurance contract held to mitigate financial risk, to the extent that the entity meets the conditions in paragraph B116 of IFRS 17.

Reinsurance contracts held: initial recognition when underlying insurance contracts are onerous

91 On balance, the IASB staff think this possible amendment would:

(a) Avoid significant loss of useful information relative to that which would be provided by IFRS 17 for users of financial statements. The accounting for the underlying insurance contracts issued would be unaffected. The accounting for the reinsurance contracts held would change but IFRS 17 already provides an exception to the general requirements for reinsurance contracts held to avoid some accounting mismatches. This possible amendment would expand the scope of the existing exception.

(b) Not be contrary to the general principle in IFRS Standards that gains should not be recognised before service is provided. This was a concern expressed by some stakeholders in response to the 2010 Exposure Draft. The IASB staff think that this possible amendment would not result in an overall gain being recognised in profit or loss because a gain on the reinsurance contract held would only be recognised to the extent that the reinsurance contract held covers a loss that is also recognised in profit or loss at the same time.

92 The IASB staff observe that exceptions, by nature, add complexity. However, in this circumstance, expanding the existing exception could reduce complexity in applying the requirements in IFRS 17 because it would introduce consistency between the accounting treatment relating to the initial recognition of underlying onerous contracts and adverse changes in underlying onerous contracts subsequently. By eliminating accounting mismatches, it could also reduce complexity for users in understanding the accounting.

93 The IASB staff think that this possible amendment might disrupt implementation for entities that have already begun to develop their systems. However, the IASB staff think that the disruption could be justified given stakeholder feedback about the likely significant impact of the accounting mismatch which some stakeholders suggest reduces the usefulness of the information provided by IFRS 17.

94 The IASB staff observe that recognising a gain for the reinsurance contract held that reflects the loss mitigation, when the reinsurance contract held is actually in a net cost position overall, is inconsistent with the principle that a reinsurance contract held is a separate contract to the underlying insurance contracts issued.

95 On balance, the IASB staff think that the benefits of expanding the existing exception in IFRS 17 to resolve the accounting mismatch that is currently outside the scope of that exception outweigh the costs of that possible amendment. The IASB staff observe that this approach links the accounting for the reinsurance contract held to the accounting for the underlying insurance contracts, and that the existing exception already introduces this link. The IASB staff think that the possible amendment would meet the criteria set by the IASB Board.

96 The IASB staff observe that a similar accounting mismatch could arise when the underlying insurance contracts are measured applying the premium allocation approach, or the reinsurance contract held is measured applying the premium allocation approach, or both.

97 The IASB staff recommend that the IASB Board amend IFRS 17 to:

(a) Expand the scope of the exception in paragraph 66(c)(ii) of IFRS 17 to require an entity to recognise a gain in profit or loss when the entity recognised losses on onerous underlying insurance contracts, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis; and

(b) Require an entity to apply the expanded exception when the entity measures contracts applying the premium allocation approach.

Reinsurance contracts: ineligibility for the variable fee approach

98 The IASB Staff emphasised that the variable fee approach was developed to give a faithful representation of insurance contracts that are substantially investment-related service contracts. Reinsurance contracts held, by definition, cannot be considered to be such contracts from the perspective of the primary insurer. IASB staff noted that for reinsurance contracts held, the insurer and reinsurer do not share in the returns on underlying items irrespective of whether the underlying insurance contracts qualify for the variable fee approach. The IASB staff noted that generally the underlying items continue to be managed by the insurer and are not transferred to the reinsurer.

99 The IASB staff noted that the IASB has decided that although some types of reinsurance contracts issued may be considered to meet the criteria to be in the scope of the variable fee approach, the variable fee approach was developed for specific types of contracts[4] and this does not apply to reinsurance contracts.

100 Therefore, the IASB staff proposed no changes to IFRS 17 on these issues.

[4] I.e. contracts with returns to the entity from a pool of underlying items that should be viewed as part of the compensation charged to the policyholder for services provided.

Appendix 2: Summary of a written response in relation to hedge accounting

Please explain your current hedging strategies

1 One member noted to apply variety of hedge programs, such as dynamic hedge programs, extreme event hedge programs, and duration enhancing programs. Some of these programs use IAS 39 hedge accounting, most programs are based on economic hedging using derivatives and non-derivatives financial instruments.

Programs applying IAS 39 hedge accounting

2 The cash flows hedges involve the use of interest rate swap agreements converting variable-rate assets to a fixed basis in order to lengthen duration and better match the cash flows of the insurance liabilities. The exposure to the variability of future cash flows is being hedged from an overall balance sheet perspective, from the interest rate movements for terms up to 30 years. Also, forward starting interest rate swap agreements are used to hedge the variability in future cash flows associated with the forecasted purchase of fixed-income assets ("reinvestment risk").

3 Fair value hedges relate to non-insurance financial assets and liabilities.

Programs based on economic hedging utilising derivatives and non-derivative financial instruments

4 The predominant economic risks being hedged are equity risk and interest rate risk. The economic hedges often relate to the minimum guarantees and the risk that the cash flows resulting from the underlying assets are insufficient to cover the guaranteed payments to policyholders.

5 Hedging under IAS 39 was not considered an option because:

(a) The hedged portfolio is an open portfolio that is updated for changes in withdrawals, mortality and new business.

(b) Where cash flow hedging is applied, often forecasted asset cash flows (reinvestments) are defined as the hedged item. This becomes more difficult, when hedging long-term exposures or when the underlying assets are managed at a higher aggregation level or by external parties.

(c) Designation of the guarantee in the insurance contract as the hedged item is not possible under IAS 39 as it is a component of a non-financial instrument.

(d) Partly, non-derivative financial instruments are used, which do not qualify as hedging instruments under IAS 39.

6 In addition, the hedging strategy may target notions other than IFRS earnings, e.g. the regulatory capital framework as the primary hedging basis.

Economic hedging of minimum (non-linear) guarantees based on FVPL

7 These programs hedge the risk that the account value or underlying assets are less than a guaranteed amount. It is the intention to predominantly hedge the equity risk, currency risk and interest rate risk associated with the liability portfolios.

8 The financial derivatives used as hedging instruments are held at FVPL which lead to volatility in equity and net income. This was addressed, amongst others, by relying on the fair value option provided in paragraph 24 of IFRS 4. This allowed to designate hedged guarantees at fair value (reducing volatility where the assets are also at FVPL) but not to fair value the host insurance contract This prevents from incurring additional income volatility due to changes in other underlying assumptions.

9 The current proposals for IFRS 17 remove the "fair value option" provided by paragraph 24 of IFRS 4 which will lead to significant accounting volatility in net income.

Economic hedging of linear guarantees

10 No hedge accounting is applied to these linear economic hedges for reasons explained above.

11 Some of these economic hedging programs use derivatives, which are reported on a FVPL bases. Some of the non-derivative instruments are carried at AFS. Under today's IFRS 4 accounting for certain liabilities, historic interest rates are applied to the insurance liabilities. Accordingly, the change in the derivatives for these liabilities are reported in profit or loss with no offsetting change in the liability being reported in profit or loss. Due to this accounting mismatch, profit or loss volatility emerges in the IFRS financial statement that does not reflect the effect of the economic hedging program.

12 IFRS 17 introduces a liability measurement based on current market interest rates, although this is supported, it leads to a significant accounting mismatch (see below).

Shadow accounting

13 This allows that all gains and losses on investments affect the measurement of the insurance assets and liabilities in the same way, regardless of whether they are realised or unrealised and regardless of whether the unrealised gains and losses are recognised in profit or loss or in OCI in the revaluation reserve.

Please explain your planned hedging strategies under IFRS 9/IFRS 17:

14 The following issues are identified in applying hedge accounting under IFRS 9/IFRS 17:

(a) A risk mitigation solution is not available for products outside the Variable Fee Approach.

(b) Risk mitigation is applicable only if derivatives are used.

(c) Risk mitigation cannot be applied retrospectively upon transition, both during the comparative period and prior to the comparative period.

15 These issues are further explained below.

Risk mitigation solution not available outside the VFA

16 Insurance products, including those that will be accounted for under IFRS 17's general model, create an exposure to financial risks such as interest rate risk or equity risk, with some or all of these risks being economically hedged through derivatives, including:

(a) Insurance products with fixed cash flows. These products are exposed to linear financial risks;

(b) Insurance products with profit sharing features and minimum return guarantees. These products are exposed to non-linear financial risks (in addition to any exposure to linear risks from fixed cash flows included in these products).

17 For products accounted for under the IFRS 17 general model, using the OCI option for changes in interest rates will result in profit or loss volatility caused by an accounting mismatch:

(a) The effect of the derivatives used for economic hedging will be recognised in profit or loss;

(b) The entire effect of interest rate changes will be recognised in OCI.

18 The option to use the profit or loss approach for the liabilities, together with using the fair value option for the financial assets, would partially eliminate this accounting mismatch. However, profit or loss will still show significant volatility from economic mismatches that otherwise could have been reported in OCI:

(a) Based on the ALM objectives, financial risks are not expected to be hedged in full (e.g. hedging based on a targeted duration gap or only hedging a minimum return guarantee);

(b) Spread changes are not necessarily reflected equally in the liability measurement.

19 The following unintended consequences may emerge from IFRS 17:

(a) If OCI is elected, additional profit or loss volatility from hedging will create a disincentive for companies to mitigate risk.

(b) If OCI is not elected, profit or loss will reflect volatility from changes in economic variables. Many of these effects will be short-term and will require considerable effort for users to analyse.

(c) ALM will be driven by accounting objectives rather than economic objectives.

(d) IFRS 17 could potentially negatively impact on the willingness and ability of companies to offer certain product types to consumers, particularly “indirect par” contracts.

20 This could be resolved by amending IFRS 17 as follows:

(a) Introduce the possibility, when applying the OCI option under the General Model, to include the effects of financial risks of the liability in profit or loss when risk-mitigated.

(b) Including these effects in PL to the extent risk-mitigated would achieve an accounting treatment consistent with that of the hedging derivatives.

(c) Risk mitigation criteria could be defined consistently with IFRS 17.B116, allowing for consistency between the General Model and the Variable Fee Approach.

<u>Risk mitigation is applicable only if derivatives are used</u>

21 Under the IFRS 17 risk mitigation approach for VFA products, risk mitigation can be applied only if derivatives are used as risk mitigating instruments, although the IASB now proposes to include reinsurance contracts held in this scope.

22 Not allowing non-derivative items as risk mitigating items could have the following unintended consequences:

(a) If non-derivatives are used for economic hedging, an accounting mismatch is created as the effect of the change in the embedded derivatives of the insurance liabilities is recognised in the CSM (under the VFA) but the effects of the hedging instruments are reported in profit or loss or OCI.

(b) IFRS 17 creates a disincentive to economically hedge with non-derivative instruments, potentially leading to suboptimal (less effective, more costly) hedging solutions.

23 This could be solved by allowing non-derivatives as hedging instruments under the risk mitigation approach for VFA products, provided the criteria under paragraph B116 of IFRS 17 are met.

<u>Risk mitigation cannot be applied retrospectively upon transition</u>

24 In their March 2019 meeting the IASB will discuss potential tentative decisions to change the IFRS 17 requirements relating to transition and risk mitigation.

If relevant, please explain why using IFRS 9 would not portray your risk mitigation strategy including the relevant hedged risk and remaining accounting mismatch

25 IFRS 9 hedge accounting is not seen as an alternative to risk mitigation for the following reasons:

(a) Achieving hedge accounting under IFRS 9 is very complex with many constraints. There are 40+ pages devoted to hedge accounting guidance as compared to two paragraphs (B115, B116) for risk mitigation guidance in IFRS 17. Furthermore, IFRS 9 does not yet include a macro hedging solution.

(b) A significant portion of the hedging is performed on a macro open portfolio with dynamic rebalancing. IFRS 9 is not designed to address these types of hedges;

(c) Achieving the hedge effectiveness criteria under IFRS 9 would be very hard due to the uncertainty of cash flows for the hedged financial risk caused by items such as additional deposits, lapses (behaviorism), early withdrawals, mortality, and morbidity. These financial and insurance risks for the insurance contracts are intertwined, and it is not immediately evident how they could be excluded from the hedging relationship;

(d) It is possible to artificially carve out some of the hedging activities into a static hedge program that would achieve hedge accounting of reinvestment risk of a block of investments. However, most companies cannot use this broadly across their hedging activities due to the significant operational constraints associated with this approach. It requires a physical separation of hedging instruments and hedge programs from the rest of the risk management activities, and the level of documentation and hedge effectiveness testing required by IFRS 9 is very extensive.

(e) There are also other considerations such as availability of hedging instruments and hedged items (for long forecasted transaction hedges), and liquidity and collateral constraints.