EFRAG Board Meeting

IASB Insurance Contracts Testing Questionnaire

Summary of findings of testing by Allianz, AXA and Prudential

Christian Knoller, Rainer Schoellhammer & David Martin

10 November 2016

Background

As part of its reaching out to 12 volunteer companies around the world, in July the IASB asked 3 members of the CFO Forum of European Insurers to volunteer to respond to its questionnaire on the 6 topics that the IASB considered the major areas of change since the 2013 ED.

The objective of the IASB was to obtain an understanding of clarity of interpretation of the requirements of the IASB Staff draft standard and the operational difficulties that could occur in applying these requirements.

Allianz, AXA and Prudential volunteered to participate in this exercise. Their responses were submitted to the IASB on 23 September 2016 and were subsequently discussed with IASB Board members and staff in individual company close-out meetings.

This document summarises the outcome of the testing. For each topic we summarise our key findings with supporting evidence from each company.

It is emphasised that this document is confined to discussion of the technical detail for only these 6 areas. It does not cover other areas of the standard or broader issues such as those that might be expected to be considered by EFRAG as it develops its draft endorsement advice.

Whilst the testing has demonstrated a number of difficulties with the standard as currently drafted for the 6 topics, we remain fully committed to support the IASB so that it is possible to finalise the standard in a reasonable timescale.

Executive summary

The questionnaire requested an assessment of the impact of the draft standard for clarity, interpretation and whether it is operational for 6 selected topics.

Our key findings include:

- Lack of clarity of some drafting leading to different interpretations
- Lack of clarity of the impact of the particular circumstance of mutualisation for certain types of participating business on the level of aggregation permitted by the IASB.
- Setting aside this special case, for the model in general the low level of aggregation permitted by the IASB gives rise to an excessive level of granularity of calculations that is not operational or useful.
- Scope of variable fee approach gives rise to inconsistent treatment of economically similar products.
- Scope of hedging proposals excludes many areas where derivatives are used to manage financial risk giving rise to accounting mismatches.
- Retrospective and simplified approaches to transition are unlikely to be practical for determining the contractual service margin level (i.e. unearned profit) in the balance sheet at the date when the standard is adopted.
- Lack of clarity as to how to interpret the fair value approach to transition which is likely to result in artificially low levels of CSM

The questionnaire did not address whether, when take as a whole, the draft standard would lead to a true and fair view of financial position and performance that would be:

- Relevant
- Reliable
- Comparable
- Understandable
- Useful to users

and would have benefits that exceed the cost of implementation.

Overview of findings of the testing for the 6 topics

	Topic 1 Level of aggregation (Unit of account)		Topic 2 Scope of Variable Fee Approach (VFA)	Topic 3 Hedging	Topic 4 Finance income /expense	Topic 5 Changes in estimates	Topic 6 Transition
	Mutualisation[1]	Other					
Clarity							
Interpretation							
Operational							

Appropriateness of IASB proposals							

Key:

Although it is acknowledged that the IASB is working on addressing the testing company concerns, the findings demonstrate fundamental issues with the clarity, interpretation and operationality of the requirements of the current draft standard or that there are major differences from the industry position.

The findings demonstrated significant issues or uncertainties in the limited time available for testing.

Sufficiently clear, interpreted consistently and capable of being applied.

[1] Mutualisation occurs where contracts include a requirement/possibility to share returns or transfer cash flows to/from policyholders of other contracts.

Key findings: Topic 1 – Level of aggregation

Requirements of the draft standard

Draft standard	There are three criteria to determine level of aggregation: 1. It is only possible to group contracts that on initial recognition have cash flows that respond in similar ways to changes in key assumptions (paragraph 36). 2. It is only possible to group contracts that on initial recognition have similar expected profitability (paragraph 36). The first two criteria dictate the level at which the test for onerous contracts is required on sale and throughout the contract term. 3. The allocation of the CSM to P&L should reflect the expected duration and size of the contracts in the group (paragraph B107).
	However, for certain types of participating business, under paragraph B68(k), fulfilment cash flows shall include payments to/from policyholders of other contracts.

<u>Approach to testing:</u>

Step 1 – Does B68(k) apply?	Contracts within scope of B68(k) - contracts that include a requirement/possibility to share returns or transfer cash flows to/from policyholders of other contracts	Contracts outside scope of B68(k) – other contracts including non-participating and non-life business
Step 2: Determine grouping criteria	Do criteria 1-3 above apply ?	Criteria 1-3 above apply
Testing findings	See slide 6	See slide 7

Clarity
Interpretation
Operational
Appropriateness of IASB proposals

Key findings: Topic 1 – Level of aggregation

For par business where the term and conditions of the contracts enable “mutualisation” of policyholder benefits:

Clarity and interpretation	▪ The interaction between paragraph B68(K) and the aggregation criteria is not clearly specified resulting in different interpretations between the testing companies.
	▪ Consequently, the IASB’s idea of mutualisation is not clearly reflected in the requirements.
	▪ Paragraph B107 goes some way to addressing concerns over excessive grouping for determining run off of CSM but concerns remain over the interpretation of “coverage units” and the ability to use approximation techniques.
Operational and appropriateness of IASB proposals	▪ In addition to issues of clarity the IASB’s proposals are too narrow in not reflecting the general perception of what mutualisation is supposed to be. For some particular types of business where the current proposals are too narrow the IASB concept of mutualisation should be extended.

Clarity
Interpretation
Operational
Appropriateness of IASB proposals

Key findings: Topic 1 – Level of aggregation

For all other business where mutualisation for particular types of participating business does not apply:

Clarity and interpretation	▪ Although there are some changes in the drafting of the requirements that are directionally helpful (such as paragraph 24 which contemplates characteristics that may enable grouping of contracts) further changes are needed to achieve an appropriate level of unit of account.
	▪ Paragraph B107 goes some way to addressing concerns over excessive grouping for determining run off of CSM but concerns remain over the interpretation of "coverage units" and the ability to use approximation techniques.
Operational	▪ The level of granularity is excessively higher than under current reporting (see detailed examples on slide 8). ▪ For business accounted for under the premium allocation approach, an onerous contract test based on the current data available, is not possible at a more granular level than homogenous risk groups.
Appropriateness of IASB proposals	▪ The 'bottom-up' assessment required under paragraph 36 is inappropriate. ▪ A revised approach that uses 'top-down' principles for identifying losses from onerous business is needed. ▪ Revision of the mandatory linear release of the CSM is needed.

Topic 1 – Level of aggregation
Impact of IASB proposals (for products without mutualisation)

Results of testing – Illustrations of how IASB proposals give a much higher level of granularity

	US fixed index annuities	Swiss P&C	Protection	Par with guarantees
Minimum number of groups under IFRS 17 proposals				
One issue year	2-6 With narrow interpretation, multiplied by factor of 10	>100	36	190
Portfolio (all issue years)	45 With narrow interpretation, multiplied by factor of 10	>100	36 groups for the business written in each reporting period	190 groups for the business written in each reporting period
Number of groups for existing reporting purposes				
	1-45	1-11	1-2	1-25

Implications

- The resulting granularity does not give rise to meaningful results for business that is managed as a portfolio.
- Significant cost and complexity due to data storage requirements and granularity of analyses
- Where stochastic modelling required to value guarantees, granular calculations will not be achievable in reporting timeframes.
- The requirement to use locked-in discount rates significantly adversely impacts reporting processes.
- Benefits of high level of granularity are illusory and potentially result in spurious accuracy.

Key findings: Topic 2 – Scope of variable fee approach

Clarity
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Draft standard	Qualification criteria for the VFA: ▪ Contractual terms specify policyholder participates in share of clearly identified pool of underlying items; ▪ Entity expects to pay policyholders *substantial* share of returns from the underlying items; and ▪ *Substantial* portion of cash flows entity expects to pay are expected to vary with underlying items.

Clarity and interpretation	▪ The interpretation of 'substantial' shares or proportions may give rise to alternative views. ▪ Although these may take time to evolve to be consistent we would expect that an industry consensus will emerge in a reasonable timescale that reflects the economics of the contracts.
Appropriateness of IASB proposals	▪ Contracts with constructive but not contractual obligations will not be within scope of the VFA despite the fact that they are managed in a similar way. For example, in Belgium a constructive obligation arises from the competitive position and policyholder expectations even though the contract is silent on participation in a clearly identified pool of underlying items. ▪ The IASB decided to exclude reinsurance contracts assumed and ceded from the VFA. ➢ We support this decision for reinsurance assumed. However, we are not aware that this is reflected in the drafting. ➢ We believe that reinsurance ceded should be accounted for in a manner consistent with the underlying business to which it relates.

Key findings: Topic 2 – Scope of variable fee approach

Examples of different interpretations

	Argument for exclusion from VFA	Arguments for inclusion within VFA
Participating contract with fixed component[1]	The fixed component may mean that the ‘substantial’ criteria are not met.	The ‘substantial criteria’ are met despite the fixed component.
US fixed index annuities	The index option is unbundled leaving a contract that does not meet the criteria for the VFA.	The index option is not unbundled. Inclusion of the option enables the contract to qualify for the VFA.

[1]In practice, virtually all participating contracts have fixed components to one degree or another

Key findings: Topic 3 - Derivatives used to mitigate financial market risk

Clarity
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Draft standard	For contracts under the variable fee approach, an entity may choose not to recognise in CSM a change in the cost of options and guarantees if, in accordance with a previously documented risk management objective and strategy, the entity uses a derivative to mitigate the financial market risk arising. In such circumstances the change in the cost of those options and guarantees, measured on a fulfilment value basis, would be recognised in profit or loss.

Appropriateness of IASB proposals	IASB addressed	P&L appropriate?	Equity appropriate?	Impact
VFA - Options & guarantees	Yes	Yes but only partial	Prospective only	▪ More volatile P&L for company that manages risk than one that does not ▪ Equity misstated at transition
VFA - Other aspects	No	No	No	Accounting mismatch
Non VFA contracts	No	No	No	Accounting mismatch

Key findings: Topic 3 - Derivatives used to mitigate financial market risk

Key findings from testing

VFA – Options & guarantees	**Residual accounting mismatch even for those arrangements that are within scope** ▪ The proposals to permit the movement in the BEL in respect of the hedged guarantees that would otherwise be reflected in CSM to be allocated to the income statement is helpful but will still leave an accounting mismatch for the differences in measurement between derivatives and the BEL for the discount rate applied. **Prospective only basis** ▪ The current proposals will give rise to misstated shareholders' equity as they restrict the adjustment on CSM allocation to the income statement to be prospective from the transition date when the phase II standard is first applied.
VFA – Other aspects	**Management of other types financial risk (i.e. other than guarantees)** ▪ The IASB's should be extended to cover other aspects of financial risk in contracts under the VFA that are managed by the use of derivatives, e.g. protecting future fee income against equity market falls.
Non-VFA contracts	**A hedging solution is also needed for risk mitigation for contracts that are to be accounted for under the general model.** ▪ For indirect participating business IFRS17 accounted for on the OCI basis will result in P&L volatility due to accounting mismatches as changes in the values of options and guarantees would be reflected in OCI while changes in the fair value of hedging derivatives would hit the P&L. For such contracts the P&L option is not a solution as this will add volatility from changes in other financial assumptions.
All contracts	**Macroeconomic management of economic risks** ▪ More broadly the lack of a comprehensive solution to reflect the macro hedging applied by insurers needs to be addressed, so as to take account of how the risk management is undertaken across different features such as types of economic risk and product, rather than the Phase II construct which has, for example, different measurement bases and granular units of account.

Key findings: Topic 4 - Determining insurance finance income or expense in OCI

Clarity	
Interpretation	
Operational	
Appropriateness of IASB proposals	

Draft standard	For participating contracts outside the VFA for which changes in financial assumptions have a substantial affect on amounts paid to policyholders, the finance income or expense can be disaggregated between P&L and OCI. Two approaches are allowed: i. Using a level systematic allocation over the life of the contract; or ii. Using a systematic allocation based on the amounts expected to be credited to policyholders
Clarity, interpretation and operational	▪ The IASB's disaggregation methods are logical. ▪ Some respondents are able to draw conclusions but for others it has not proved possible to determine which of the methods they would use. ▪ For non-VFA contracts, the expected crediting rate will be very complex, in particular with regard to retrospective application at transition. However applying a level yield instead may result in material accounting mismatch.
Appropriateness of IASB proposals	▪ Under the VFA, the requirement to recycle from OCI to profit or loss any remaining contracts that are derecognised results in an accounting mismatch if underlying items are accounted for at FVOCI without recycling (e.g. equities) ▪ Where a mix of assets at fair value and through OCI apply for contracts outside the scope of the variable fee approach inconsistencies in earnings pattern and accounting mismatches may arise. ▪ These difficulties illustrate why further consideration is needed in this area before the standard is finalised.

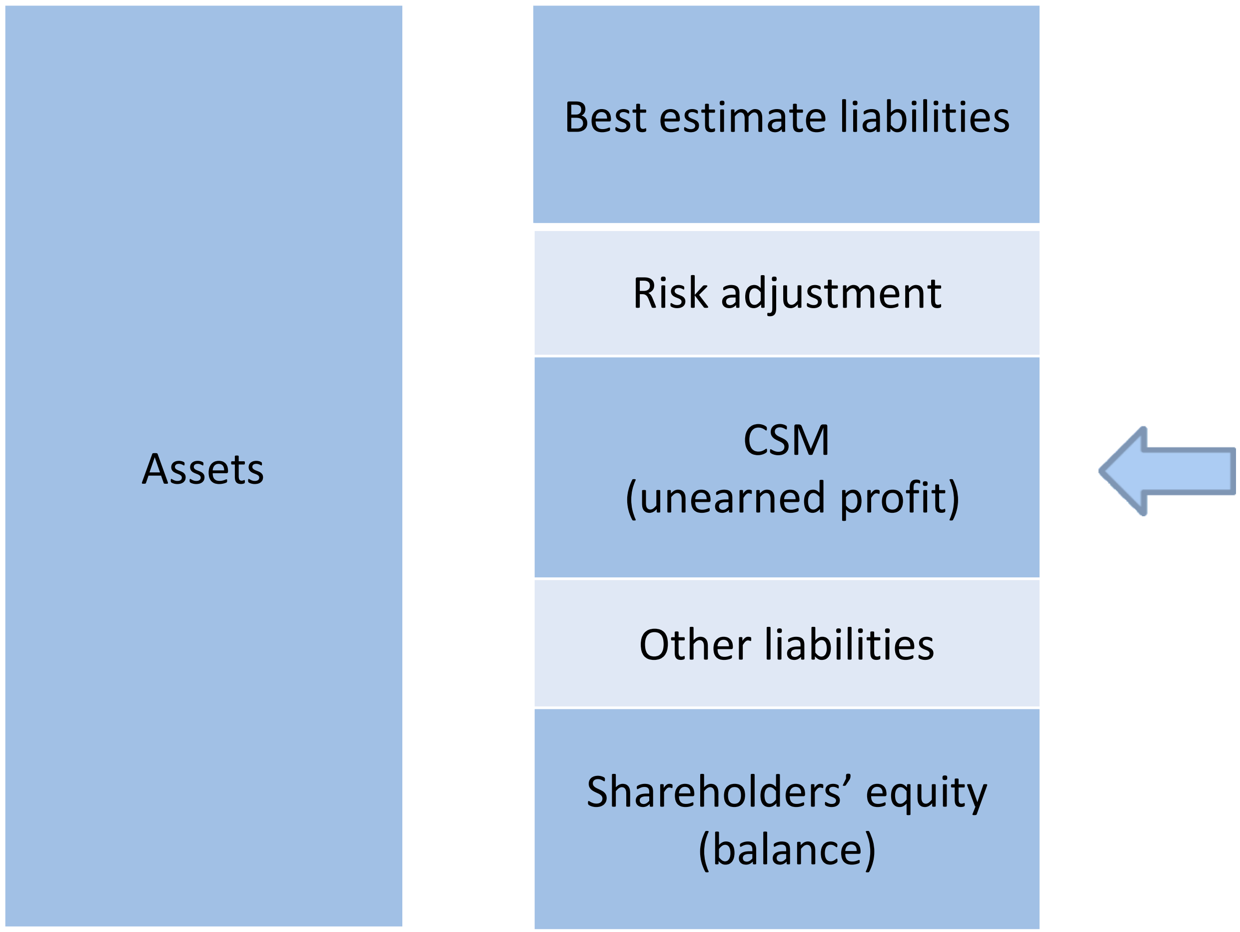
Key findings: Topic 5 - Recognition of changes in estimates

Clarity
Interpretation
Operational
Appropriateness of IASB proposals

Draft standard	Changes to expected future cash flows, in particular the amounts paid to policyholders, can result from changes to financial market assumptions or the exercise of discretion by the insurer. ▪ Under the VFA, both changes are taken to the CSM. ▪ For contracts outside the VFA, the impact of the exercise of discretion is taken to CSM while the impact of changes in financial market assumptions is taken to P&L or OCI.
Findings of testing	▪ There is lack of clarity over how to interpret what constitutes 'discretion' for contracts outside the VFA, i.e. indirect par business. The interpretation is important as it drives the allocation between P&L, OCI and CSM. ▪ It is suggested that the standard is changed to clarify that, on inception, an entity is required to define the mechanism used to determine the amounts paid to policyholders (e.g. using a formula). Changes in the mechanism would constitute the exercise of discretion and would therefore be taken to CSM. ▪ Paragraph B93.a.ii would require for non-VFA contracts that all experience adjustments that impact future cash flows unlock the CSM, which would not result in a meaningful revenue and net income, e.g. in the case of a pandemic event. ▪ There is uncertainty as to whether or not the IASB proposals give rise to meaningful information that is transparent and useful to users, thus reinforcing the need for further consideration in this area before the standard is finalised.

Key findings: Topic 6 – Transition

Requirements of the draft standard



At the beginning of the earliest period presented, the CSM should be calculated on:

i. A fully retrospective approach;
ii. A simplified retrospective approach ; or
iii. A fair value basis

Clarity
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Key findings: Topic 6 - Transition

Clarity of drafting	▪ Concern regarding the drafting of paragraph C11(a) regarding misalignment of dates.
Issues of interpretation	▪ We are concerned at the practical application and interpretation of the fair value approach: ➢ If the 'fair value of the insurance contracts' only refers to the liability component (i.e., comparing expected future cash flows and risk adjustment on a fair value and a fulfilment value basis), this would result in a near zero CSM which would not be meaningful. ➢ Consequently, the fair value should reflect underlying items. These would typically be transferred with the obligations if the contracts are sold. This would result in a more meaningful fair value.
Operational considerations	▪ Data gaps are likely to make both the fully retrospective option and the simplified approach impractical to apply. This is illustrated on the following slide. The need for simplification is essential. ▪ In addition to the need to apply a more sensible and less granular approach to the unit of account for ongoing reporting, further simplifications are needed for determining the CSM at transition.
Appropriateness of IASB proposals	▪ Technical issues in the way that the CSM at transition is mandated under the simplified approach which makes impossible, as a matter of principle, the ability to determine comparative results for prior periods. For example if first adopted at 1 January 2021 it will not be possible under the draft standard to "roll back" the movements on the CSM before that date. ▪ Concern that the standard places a restriction preventing new contracts being added to a transition portfolio. ▪ The simplified approach should result in meaningful transition CSMs that ensure comparability of results in future years.

Topic 6 – Transition

Operational issues

Examples of practical constraints affecting the ability to perform retrospective calculations (including the simplified approach):
▪ Lack of availability of historic data – e.g. administration systems often do not store the premium payment history ▪ Actuarial valuation models are developed over time. Consequently, it is often not be possible to run existing actuarial valuation models on historic data. ▪ Historic cash flow data is only available for a limited number of years. ▪ Historic cash flow data is only available to a limited level of granularity. ▪ Historic assumption sets (e.g. used to determine best estimate liabilities) are only available for a limited number of years.